

# NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



## THESIS

**CASE STUDIES IN EAST ASIAN ECONOMIC  
DEVELOPMENT: THE REPUBLIC OF KOREA  
AND THE PEOPLE'S REPUBLIC OF CHINA**

by

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December, 1995

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THE REPUBLIC OF KOREA AND  
THE PEOPLE'S REPUBLIC OF CHINA**

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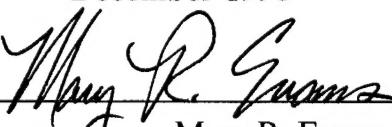
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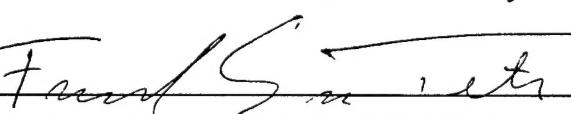
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## ABSTRACT

Since the end of the Cold War, economic strength has become the leading symbol of power and means of achieving peace and stability. East Asia is widely viewed as *the up-and-coming economic power center*. Examination of East Asian economic development can provide some useful insights into overall patterns of development and influence, and suggest the path to a post-Cold War world future of peace and prosperity. This thesis provides two representative case studies: the Republic of Korea and the People's Republic of China. These studies emphasize the importance of external (foreign) development assistance to modernization in lesser developed countries (LDCs) and the roles played by the United States and Japan as the world's major sources of such assistance. Findings include: (1) LDCs can make extensive use of foreign development assistance without losing control -- or sovereignty -- over their economies of the direction of their development; (2) mature, industrialized economies can provide large amounts of assistance to LDCs without destroying their own economic futures; (3) the experience of the East Asians can provide useful alternatives for LDCs worldwide; and (4) a partnership has emerged between the United States and Japan as sources of development assistance.



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## EXECUTIVE SUMMARY

An international shift in emphasis since the end of the Cold War has placed economic strength above military might as a symbol of power and means of achieving peace and stability. The problems of lesser developed countries (LDCs) and the "North-South" debate are among the most vital issues in the contemporary world.

This thesis provides two representative case studies in East Asian economic development: the Republic of Korea and the People's Republic of China. These studies emphasize the importance of external (foreign) development assistance to modernization in lesser developed countries (LDCs) and the roles played by the United States and Japan as the world's major sources of such assistance. Four forms of development assistance -- aid, trade, investment and technology transfer are used as indicators to measure influence.

Economic development in East Asia has captured global attention and concern in recent years. The area is widely viewed as *the up-and-coming economic power center*. I submit that an examination of East Asian economic development can provide some useful insights into overall patterns of economic development and influence, and could suggest the path to a post-Cold War world future of peace and prosperity. For such an examination to be useful in this way, several questions must be answered:

- Can LDCs solve the dilemma of accepting and using large amounts of external development assistance without losing control -- or sovereignty -- over their economies or the direction of their development?
- Similarly, can mature, industrialized economies solve the dilemma of providing large amounts of assistance to LDCs without destroying their own economic futures?

- Has an “East Asian model” of economic development emerged that could be useful for LDCs worldwide?
- As the world’s two largest sources of development assistance, can the United States and Japan function as partners, or must one of them clearly establish a leading role?

Today more than ever, external (foreign) assistance is critical to the development of LDCs seeking to modernize. The United States has been considered the leading contributor of development assistance to LDCs worldwide since the end of World War II; Japan has exercised increasing influence in this area over the past three decades, particularly among its East Asian neighbors. I argue that: (1) the dilemmas faced by both the LDCs and mature, industrialized economies can be resolved with favorable results through cooperative management of assistance resources, (2) the experience of the East Asians can provide useful alternatives for LDCs worldwide, and (3) a partnership has emerged between the United States and Japan as sources of development assistance -- assuming a clear lead is unnecessary for either.

Based upon my findings, I consider America’s national interests and its evolving role in the Asia-Pacific community and conclude with some recommendations for future United States policy. *Complementary* foreign and domestic policies are needed to protect our national interests. Neither set can subordinate the other and produce a favorable outcome over the long run. Today, American leadership in the Asia-Pacific community is not optional: interdependence demands active participation; our size and strength demand a responsible role. Further, as the one remaining “superpower” in these early years of the post-Cold War era, America’s *global* responsibilities have not diminished. Therefore it is especially important now that we not lose sight of our responsibilities -- and our position -- within the international community.

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## I. INTRODUCTION

Internationally -- particularly since the end of the Cold War -- emphasis has shifted from military to economic strength as a symbol of power and means of achieving peace and stability. The problems of lesser developed countries (LDCs) and the "North-South" debate are among the most vital issues in the contemporary world. Today more than ever, external (foreign) assistance is critical to the development of LDCs seeking to modernize. The United States has been considered the leading contributor of development assistance to LDCs worldwide since the end of World War II. However, during the last thirty years Japan has exercised increasing influence in this area, especially in East Asia. Together the United States and Japan produce 40 percent of the gross world product, 85 percent of the world's leading-edge technology and are the two greatest worldwide resources of development assistance (Chung, ed., 1991). Their contributions and influence over the development of LDCs have taken many forms, but have primarily consisted of aid,<sup>1</sup> trade, investment, and technology transfer.

Economic development in East Asia has captured global attention and concern in recent years. The area is widely viewed as *the up-and-coming economic power center*: it is regarded as both an opportunity for expansion and as a potential threat to the economies of mature, industrialized countries. In this respect, the Republic of Korea and the People's Republic of China hold special positions. The Republic of Korea -- now a thriving medium-developed country -- is the first and perhaps most powerful of the East Asian LDCs to become integrated into the capitalist world economy. Also, continuing instability on the Korean peninsula significantly affects the security interests of all East Asian powers. In contrast, the People's Republic of China is the East Asian "late bloomer," having only

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<sup>1</sup>Aid is given in a variety of forms, ranging from outright grants to loans at market rates.

recently adopted a form of capitalism and entered the world economy. It is widely speculated that a prosperous China with a revised, more pragmatic ideology will become an economic "giant" within the next few decades; its success could present the rest of the world with a very different economic and political situation.

Because of their special positions, a comparative study of economic development in these two countries can provide some useful insights into overall patterns of development and influence within the region. Further, "lessons learned" from successes and problems encountered in South Korean and Chinese development could suggest the path to a post-Cold War world future of peace and prosperity. To be useful in this way, the East Asian cases must answer several questions:

- Can LDCs solve the dilemma of accepting and using large amounts of external development assistance without losing control -- or sovereignty -- over their economies or the direction of their development?
- Similarly, can mature, industrialized economies solve the dilemma of providing large amounts of assistance to LDCs without destroying their own economic futures?
- Has an "East Asian model" of economic development emerged that could be useful for LDCs worldwide?
- As the world's two largest sources of development assistance, can the United States and Japan function as partners, or must one of them clearly establish a leading role?

The following chapters provide an examination of individual cases<sup>2</sup> (Chapters II and III), summary analyses of general patterns, practices and policies used by the developing and

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<sup>2</sup>The relative detail and length of each case study reflect the complexity of the corresponding country's economic development process. Although the South Korean government was changed by military coup, neither its overall form nor outward-oriented, capitalistic path to development were significantly altered. In contrast, a range of cyclical changes in the Chinese government's policies strongly affected that country's path to economic development.

mature, industrialized economies, and conclusions (Chapter IV). Four forms of development assistance -- aid, trade, investment and technology transfer -- are used as indicators to measure economic influence. This study proposes three arguments: (1) the dilemmas faced by both the LDCs and mature, industrialized economies can be resolved with favorable results through cooperative management of assistance resources, (2) the experience of the East Asians can provide useful alternatives for LDCs worldwide, and (3) a partnership has emerged between the United States and Japan as sources of development assistance -- assuming a clear lead is unnecessary for either.

The fundamental purpose of this study is to make recommendations for a more effective policy in protecting and promoting the national interests of the United States in the ever-changing strategic environment of the Asia-Pacific community. Suggested initiatives, both in domestic and foreign policy are clearly indicated in my concluding chapter.



## II. THE REPUBLIC OF KOREA: CASE STUDY

### A. BACKGROUND: POSTWAR RECOVERY - THE 1950s

#### 1. After the Korean War

The Republic of Korea emerged from the Armistice in 1953 virtually without infrastructure, industry or an economy. Suffering perhaps a million casualties in the war, the country had also lost some 40 percent of its structures and two-thirds of its industry. Damage estimates range from over \$2-5 billion dollars and suggest that most of the pre-1950 capital investment was destroyed. Agricultural production was down to around 27 percent below that of prewar years and per capita income had sunk to \$67. (Steinberg, 1990)

Foreign assistance -- food, funding, military and diplomatic -- was essential for both survival and development. Over \$2 billion dollars poured into the country during the 1950s, the United States being the main single contributor (Mitchell, 1988). American commitments included \$1 billion in direct grant aid over three years, with an additional \$600 million or so through the United Nations Korea Reconstruction Agency (UNKRA) (Macdonald, 1990). But much of the aid was not used effectively. A large percentage -- especially in the early 1950s -- came as either nonessential consumer goods or agricultural surplus items instead of capital for redevelopment. Despite this bleak picture several important elements existed that would contribute to the South Korean "economic miracle."

#### 2. Foundations for Growth

Japanese colonialism gave Korea improved agriculture and a modern framework of infrastructure, industry, education and training. A part of this framework in the south,

including the railway system and the textile industry survived the war. Colonial development also accelerated urbanization: Korean population in cities of 20,000 or more people increased from about 6 percent to 20 percent of the total population between 1910 and 1941 (Eckert, et al., 1990). In 1946 the United States Military Government estimated that 17 percent of the South Korean population lived in cities of 50,000 or more people (Mitchell, 1988). Though most of the colonial urban population consisted of factory wage workers, the Japanese allowed a few Koreans to develop as an elite group of businessmen, bureaucrats, white-collar workers and other modern professionals. Together these urban workers and elite would later form the nucleus of South Korea's new capitalist society.

Korean tradition -- heavily influenced by Chinese Confucianism -- places strong emphasis on education, hard work and stability in employment. Despite other conditions postwar development of human capital was not impeded. South Koreans increased the demand for education at all levels. Illiteracy fell from as high as 78 percent in 1945 to 27.9 percent in 1960; the number persons enrolled in higher education increased from 34,000 in 1952 to 101,000 in 1960. By the early 1960s demand for education became so great that many graduates were unemployed. (Mitchell, 1988)

Several factors greatly equalized income distribution. Most of the losses in the Korean War had been borne by the wealthy. Confiscation and redistribution of Japanese property after 1945 and land reform -- forced sale of wealthy Korean landowners' property in excess of three hectares below market prices -- put land in the hands of many small tenant farmers. A farm price support program with subsidized low food prices for consumers enhanced parity between urban and rural incomes.

The Korean War experience also provided a common ground from which social classes could work together toward shared goals of reconstruction and development. And since the liberation from Japan every school child was taught that Korea had transmitted civilization to the Japanese. Therefore it was unthinkable that the Republic of Korea could not do what Japan had done -- and do it faster and better.

### **3. Import Substitution and Maximization of Foreign Aid**

South Korea exported mainly traditional products through the 1950s. Domestic industrial production was concentrated toward food and other minimum subsistence level consumables. However, some export revenues were used to purchase producer goods for industries producing nondurable consumer goods for the home market. Domestically produced goods gradually replaced imports: by the late 1950s export expansion contributed only 5.1 percent to the growth of manufactured output, whereas import substitution contributed 24.2 percent, and domestic demand, 70.7 percent (Chenery and Srinivasan, 1989). Import substitution and protectionist tactics such as tariffs, import licensing regulations, overvalued exchange rates and artificially low interest rates allowed growth in the manufacturing sector, particularly in the textile industry.

However, the general economy experienced little growth under President Syngman Rhee (1948-60). Growth in the South Korean gross national product (GNP) averaged roughly 4 percent per year, but a population growth rate of nearly 3 percent per year absorbed most of the economic growth (Macdonald, 1990). By 1960 per capita income was still low at only \$82 (Mitchell, 1988). Instead of developing a long-range strategy or plan for development, the Rhee administration used as much foreign aid as possible to run the country. United States aid alone provided more than one-third of the South Korean government's budget between 1953 and 1962: it paid for approximately 85 percent of the country's imports, accounted for 75 percent of total fixed capital formation and 8 percent of GNP (Steinberg, 1990). Because President Rhee's ultimate goal was to achieve a reunited Korea under his control, massive industrial development in the south was not a top priority: there was no intention to replace what had been left behind in the north.

The United States aid development program initiated in 1954-55 offered little to technical advancement in the Republic of Korea. A congressional subcommittee report labeled America's impact as "modernizing but distorted and unbalanced." (Amsden, 1989)

Most projects focused on small-scale light manufacturing enterprises. Only a few large-scale projects in basic industry were attempted and most of them ran into snags. The Americans were effective in teaching quality control -- especially in the construction industry -- but the transfer of technology on a large scale basis was problematic at best.

Modest progress was evident by 1960, however: the agricultural and industrial sectors were growing, urbanization proceeding, the population becoming better educated and workers receiving modern, specialized training in skills necessary for development. But most of the society's latent potential remained untapped. A much different kind of leadership was required to make effective use of it. President Rhee's forced resignation in 1960 and subsequent governmental attempts at political reform brought no real change in economic policy. The leadership necessary for development appeared with General Park Chung Hee's military coup in 1961.

## **B. TRANSFORMATION - THE 1960s AND '70s**

### **1. Export Promotion and Rapid Growth**

The Park regime (1961-79) represented a return to the relatively autonomous, economically-oriented government of the Japanese colonial era. Taking over a country that was among the poorest in the world, it set out to create a climate in which economic growth could become an achievable national goal. Approximately 85 percent of the nation's GNP growth in the early 1960s can be attributed to the rational use of existing resources (Mitchell, 1988). A series of Five-Year Plans were developed to promote rapid, sustained growth, the first of which became effective in 1962. Expansion occurred in both the agricultural and industrial sectors, but after 1962 rapid expansion in manufacturing marked the beginning of a structural transformation that would lead to high rates of economic growth. As shown in

Table 2-1 below, manufacturing and industry maintained high average annual growth rates while agriculture experienced a relative decrease over time.

Table 2-1. Average Annual Growth Rates (percentage).  
(After *World Development Report*, various)

	1960-70	1970-80
Gross National Product	8.5	9.6
Agriculture	4.5	2.7
Industry	17.2	15.2
Manufacturing	17.2	17
Services, Etc.	8.4	8.8

The South Korean government's role was crucial to achievement of the high growth rates in gross national product shown in Table 2-1. Perhaps the most important policy change made was to shift emphasis from import-substitution to export-led growth. Trade as the engine of economic growth is widely recognized by contemporary analysts. Turning to foreign markets allows for expansion and the development of beneficial economies of scale for participating industries. Increasing the sophistication of export products both helps and is helped by the process of industrialization. Studies have shown that growth in exports of manufactured goods not only increases national income -- it also contributes to the economy's structural transformation from agriculture and simple manufactures to more sophisticated products. (Trehan, 1994)

Devaluation of the won in 1960 and the Park administration's tactics -- removing some of the trade restrictions with Japan and providing special tax, licensing and financial privileges to exporters in targeted industries<sup>3</sup> -- produced a rapid growth of exports. As shown in

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<sup>3</sup>However, subsidies and privileges given to targeted industries were not giveaways. They were distributed on the principle of reciprocity: in exchange, the government imposed performance standards and discipline on private firms. Interestingly enough, performance was measured in terms of production and

Table 2-2, South Korean exports increased over five to six times in dollar value during each of the five-year increments between 1960 and 1970.

Table 2-2. Total Exports (millions of U.S. dollars). (After *The Far East and Australasia and World Development Report*, various)

1960	1965	1970	1975	1980
33	175	835	5,081	17,505

The government also invested heavily in ports, roads, communications and other export related infrastructure, and protected fledgling industries with tight import controls.

Early exports of labor-intensive products such as textiles, clothing and footwear came mostly from medium-sized firms, but big businesses<sup>4</sup> played a large part in leading the export charge of the early 1960s. Although they produced less than half the country's total industrial output during that time, they produced 77 percent of its exports (Mitchell, 1988). One distinctive and unusual characteristic of South Korean economic development was the government's deliberate encouragement of the growth of large, predominantly family-controlled conglomerates -- the *chaebol*. The *chaebol* were the Park administration's instrument of choice for promotion of industrialization and export-led growth. They were easily subjected to state intervention and direction because of their substantial indebtedness to government-sponsored or government-approved institutions. In return, the *chaebol* usually had better global marketing facilities and more highly skilled, higher paid workers. Copious amounts of government credit at below market rates enabled their rapid transition in the 1970s to capital-intensive exports such as steel, ships, automobiles and electronics.

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operations management (efficiency) rather than financial indicators. Poor performers were penalized and good performers rewarded: institutional credit and other forms of financial support were commonly used as tools to meet these ends.

<sup>4</sup>Defined as employing over 300 people.

By the late 1960s the export market was beginning to outstrip the domestic market in shares of industrial production. Also, manufactured exports began to grow faster than non-manufactured exports. As shown in Table 2-3 below, the most dramatic changes occurred between 1960 and 1970.

Table 2-3. Percentage Shares of Merchandise Exports. (After Steinberg, 1990 and *World Development Report*, various)

	Fuels, Minerals and Metals	Other Primary Commodities	Textiles and Clothing	Machinery and Transportation Equipment	Other Manufactures
1960	30	56	8	N/A	6
1965	15	25	27	3	56
1970	7	17	36	7	69
1976	3	9	36	17	35
1981	2	8	30	22	38

The United States and Japan generally dominated the South Korean export market. Even without formal diplomatic relations, trade with Japan started to grow in the 1950s;<sup>5</sup> President Park's relaxation of constraints and policies concerning Japan cleared the way for a considerable amount of two-way trade in the early 1960s. Japan was in fact the largest market for South Korean exports between 1960 and 1964. However, by 1965 the United States overtook Japan and has maintained its relative position since (see Table 2-4 below).

Despite the vast increases in exports the Republic of Korea has maintained a negative trade balance in every year of its existence as a free state. As with exports, the United States and Japan have dominated its import market. The United States was the primary supplier

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<sup>5</sup>Close private personal and professional relationships between Koreans and Japanese during the colonial period were maintained after the end of World War II. Particularly among the Korean elite, Japanese literature continued to provide the latest information on economic trends and industrial technology.

early on, but yielded the position to Japan after 1965 (see Table 2-5 below). Japan also became the country's main source of consumer electronics components. Comparative market and technological advantages, along with close geographic -- and to some extent, cultural -- proximity made Japan the best sourcing alternative. Also, the supply was reliable: divisions within Japanese companies are often autonomous and will sell aggressively, even if it is to the detriment of a sister division.

Table 2-4. Exports to the Japan and the United States (millions of U.S. dollars/percentage of total). (After *The Far East and Australasia, World Development Report* and *The Summary Report: Trade of Japan*, various)

	1960	1965	1970	1975	1980
Total exports	33	175	835	5,081	17,505
To Japan	20.2	44	234	1,293	3,093
To the U.S.	3.6	62	395	1,536	4,607
Japan%	61.2	25.1	28.0	25.5	17.4
U.S. %	10.9	35.4	47.3	30.2	26.3

Table 2-5. Imports from the United States and Japan (millions of U.S. dollars/percentage of total). (After *The Far East and Australasia, World Development Report* and *The Summary Report: Trade of Japan*, various)

	1960	1965	1970	1975	1980
Total import	344	463	1,984	7,274	22,292
From U.S.	133.8	182	585	1,881	4,890
From Japan	70.4	167	809	2,434	5,858
U.S. %	35.4	39.3	29.5	25.9	21.9
Japan %	20.5	36.1	40.8	33.5	26.3

With exports increasing exponentially in the early 1970s, the South Korean government started to emphasize development of new heavy and chemical industries and more balance in regional development. A watershed in the industrial history of the Republic of Korea was the creation of competitiveness in steel. Not only was this a sector in which competitiveness depended upon higher productivity, but it was also one in which the Korean's model and teacher, Japan, was also its major competitor. It also signified the country's turn to heavy industry. The Pohang Iron and Steel Company, Ltd. (POSCO) was founded by the South Korean government in 1968 with Japanese assistance funds. The company began production five years later with an annual capacity of 1.03 million metric tons of crude steel; by 1983 annual production was up to 9.1 million metric tons (Amsden, 1989).

The 1973 oil crisis prompted a push by the South Korean government to diversify markets through the creation of general trading companies and direct trade diplomacy. This yielded two major successes: penetration of the European market, largely with products developed for the United States and Japan, and penetration of the oil-exporting country (OPEC) markets, most notably Saudi Arabia. The opening of OPEC country markets was closely related to the growth of South Korean overseas construction companies that could use domestic construction materials and equipment in the Middle East. Increased numbers of Koreans in those countries resulted in more exports, both to expatriate Koreans and the local population.

Another push following the oil crisis was to deepen the country's industrial structure by promoting *skilled* labor intensive industries such as electronics and shipbuilding. This change in industrial policy was justified by the government as necessary for international competitiveness.

Export promotion and industrial development made use of the one abundant resource in the Republic of Korea -- cheap labor. After 1963 manufactured exports alone absorbed as much as half the country's labor force growth (Gillis, et al., 1992). Between 1966 and

1976 the number of manufacturing firms increased by 10 percent; the number of employees per enterprise increased by 175 percent (Meier, 1989).

## **2. Financing Development: Aid, Loans and Investment**

Foreign aid to South Korea between 1945 and the early 1980s probably totaled over \$26 billion, much of it in concessional or grant form. About \$41.7 billion was received in foreign lending and grants between 1962 and 1981. (Steinberg, 1985) Reconstruction and development were largely financed with foreign aid through the 1960s. American security-oriented aid constituted 96 percent of the country's defense budget in 1960; between 1954 and its termination in 1971 receipts amounted to \$2.3 billion. By the mid-1960s, however, the South Korean economy was growing so rapidly that aid from the United States -- its primary donor -- was phased out. American aid dwindled to \$37 million by 1974-75. (Lee and Sato, 1982) Foreign loans began to replace aid as a means of finance.

The most important new relationship for aid, trade and investment purposes came in 1965 with normalization in relations with Japan. Strongly promoted by the United States, the settlement between Japan and the Republic of Korea amounted to some \$800 million to be distributed over a 10-year period (1966-75): \$300 million in grants, \$200 million in concessional loans, and some \$300 million in commercial credits (Steinberg, 1985). By 1970 Japan provided \$123 million in grants, \$75 million in loans and \$380 million in commercial credits (Lee and Sato, 1982). After much negotiation an agreement for an additional \$4 billion in support over seven years was reached in 1983 (Yasutomo, 1986). Although Japan's contributions of Official Development Assistance (ODA) totaled less than those from the United States, they represented a much larger percentage of the donor country's total worldwide disbursements (see Table 2-6 below).

Table 2-6. Official Development Assistance from the United States and Japan (millions of U.S. dollars). (After *Development Co-Operation*, 1992)

	1970-1971	1980-1981
Total U.S. ODA (cumulative)	3,328	6,973
Total Japan ODA (cumulative)	555	3,592
% Total U.S. disbursements	4.5	0.6
% Total Japan disbursements	19.8	6.9

South Korean military participation in the Vietnam War yielded considerable economic and military dividends. In return for participation, over \$1 billion in security assistance funds, military procurements, development loans, cash allowances and arms transfers were received from the United States between 1965 and 1970. Another \$1 billion or so earned by various businesses associated with the war made up 10 to 20 percent of the country's current account receipts during this period. (Lee and Sato, 1982)

In the 25 years following the 1961 coup, the phenomenal growth of the South Korean economy was routinely interrupted by internal and external shocks. As Amsden (1989) wrote:

What with two oil crises, global depression, and an intensification of international competition, the 1970s were difficult years in which to industrialize. Nevertheless, external shocks did not derail the Korean economy from its fast-track growth. *The government borrowed its way out of balance-of-payments difficulties and sustained fast growth.*

Foreign loans have been used primarily to finance long-term investments and solve balance-of-payment crises. The country's big buildup of foreign debt began between 1966 and 1971. Loans during that time were used to finance exports, imports of capital goods in the light manufacturing sector, the first import-substitution in heavy industry (fertilizers and cement), and investments in infrastructure. Between 1962 and early 1984 the World Bank provided approximately \$5.3 billion in assistance to the Republic of Korea. The Asian Development Bank provided approximately \$1.4 billion between 1968 and 1984. (Steinberg, 1985) Both

banks made major investments in infrastructure and provided substantial funding to South Korean banks and institutions for relending to industry.

The Republic of Korea relied more on foreign borrowing than investment. Except for 1965 and 1972-73, direct foreign investment remained under 10 percent of the total of foreign capital entering the country through the late 1980s (Mitchell, 1988). Much of it came as machinery and plant, some of it even secondhand. Foreign investments in the form of equity ownership of production facilities have been minimal. For many years, foreign investors were welcomed in the light manufacturing export sector but discouraged from the import-substitution sectors such as heavy industry and pharmaceuticals. Foreign companies not involved in one of the free trade zones started in the mid-1970s at Masan and Iri were not allowed to own more than half equity.

A peak in radio exports drew attention to the Republic of Korea in 1966 as an attractive offshore assembly base for foreign firms. Operations by a number of American companies were followed by a series of joint ventures between Japanese and local firms. In 1968 foreign firms produced 71 percent of exports, local firms 21 percent, and joint ventures 8 percent. But the South Korean preference for going it alone is strong: by 1980 domestic firms were producing 48 percent of exports, foreign firms 37 percent and joint ventures 15 percent. (Mitchell, 1988)

Starting in the 1980s the South Korean government began encouraging more foreign investment in high-technology industries. Failure to meet the goals of the Fourth Five-Year Plan (1977-81)<sup>6</sup> reinforced a general desire for a much more open economy. Any investment was felt to be good investment and equity ownership of up to 100 percent for foreign investors became possible.

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<sup>6</sup>Goals were not met for a number of reasons, including the second oil crisis and President Park's assassination in 1979, and a disastrous harvest in 1980.

Japan and the United States also dominated South Korea's direct foreign investment. As shown in Table 2-7, Japan was clearly the leader. Japanese investors concentrated in hotels, tourism and electronics, Americans, in manufacturing facilities.

Table 2-7. Cumulative Direct Foreign Investment from Japan and the United States (millions of U.S. dollars). (After Lee and Sato, 1982 and Steinberg, 1985)

	1962-1978	Through 1983
Japan total	583.6	843.4
U.S. total	193.9	409.7
Japan % of ROK total	57.9	49.5
U.S. % of ROK fTotal	19.2	29.1

### 3. Importing Technology

The Republic of Korea got the best of both worlds in terms of technology transfer. From 1945 to 1965 transfers through tied aid came mostly from the United States, which was at the height of technological world supremacy. Military-related technology transfers -- probably the most effectively transferred type of American technology -- "... also had the virtue of not being subject to profit-maximizing goals on the part of the teacher." (Amsden, 1989) After 1965 transfers mainly came from Japan, when it was in the process of becoming one of the world's top producers of technology.

Transfers from Japan in fact began before 1965. For example, in the electronics industry two South Korean transistor plants were set up in 1961-62 under the technical guidance of two Japanese companies (Matsushita and Sanyo) -- although relations were not yet normalized and joint ventures between the two countries were not legally permissible at the time.

Over time the central tendency shifted from absorption of foreign technology through copying and learning-by-doing to adoption of foreign technology through investment in foreign licenses and technical assistance. South Koreans have viewed massive imports of licenses and assistance as means of achieving technological independence and avoiding foreign control. Approximately 3,500 contracts were negotiated between 1962 and 1985 for the sum of \$1.3 billion (Kang, 1989). Between 1962 and 1977 transfers from Japan were roughly double those from the United States, as indicated in Table 2-8.

Table 2-8. Technology Transfers from Japan and the United States 1962-77  
(millions of U.S. dollars). (After Lee and Sato, 1982)

	Amount	Number of Cases	Percent of ROK Total
From Japan	89.1	564	51.9
From the U.S.	46.9	209	27.3

Official statistics provide an incomplete picture: they exclude informal transfers from sources such as machinery suppliers and independent consultants. Technology has been transferred formally about one-third of the time, but informal means have proven much more effective. Trade has been used to develop technology perhaps more than any other means. Instruction from machinery suppliers, as part of capital goods purchases, provided the Republic of Korea with such productivity-enhancing technology as the (Japanese) free flow or worker-paced assembly line in the electronics industry. Because most of its capital equipment was imported from Japan, South Korean industries also imported highly efficient Japanese production practices.

Some examples of profitable technology transfers can be associated to specific industries. Through Pohang Steel Company came technology relating to investment capability (preinvestment feasibility studies, manpower training and project execution) and production capability (process engineering and production control) from Japan. Hyundai

Motor Corporation sought technology from several sources, sometimes using two different sources for the same technology. Between 1974 and 1976 Hyundai received transfers in automotive design and construction from Japan, England and Italy. Ability to absorb these technologies came through technical assistance from the United States (Ford), but production know-how came from Japan. Hyundai Heavy Industries received transfers through technical assistance in four areas: dockyard design from Scotland, ship design and operating instructions from Scotland, hands-on training from Norwegian shipbuilders employed in its early years of operation, and production know-how from Japan.

In the electronics industry development generally proceeds in four stages: (1) assembly for the local market, (2) direct foreign investment, (3) domestic mastery of existing processes and technology licensing, and (4) production at the forefront of existing technology. Arrangements with Japanese companies made South Korea's first stage production good enough to allow limited exports. Transfer of skilled local staff from foreign-invested to locally-owned firms expedited transition from the second to third stage. "From interviews it seems that most production executives commenced work for foreign firms and then turned to domestic firms, bringing their technical skills with them." (Mitchell, 1988)

## **C. CONTEMPORARY ISSUES IN A MATURING ECONOMY - THE 1980s AND '90s**

### **1. The Domestic Situation**

The South Korean economy continued to grow at a steady pace through the 1980s. As shown in Table 2-9 below, gross national product continued to grow at an average annual rate of 9.6 percent between 1980-91. Growth in agriculture, industry and manufacturing slowed somewhat, while the services sector continued to grow steadily -- an indicator that the economy was beginning to mature. By mid-1992 the Republic of Korea was well

established as a medium-developed country with an annual per capita income of \$6,790 (*World Development Report*, 1994).

Table 2-9. Average Annual Growth Rates (percentage).  
(After *World Development Report*, various)

	1970-80	1980-91
Gross National Product	9.6	9.6
Agriculture	2.7	2.1
Industry	15.2	12.1
Manufacturing	17	12.4
Services, Etc.	8.8	9.3

## 2. Complex Interdependence

According to Robert Keohane and Joseph Nye (1977), complex interdependence has three main characteristics: (1) societies are connected by multiple channels - formal (governmental), informal (non-governmental) and transnational (multinational organizations, etc.); (2) relationships between states consist of multiple issues that are not arranged by any clear or consistent hierarchy; and (3) military force is not used between governments in the region or on the issues over which the interdependence prevails. Current relationships between the Republic of Korea, Japan and the United States approximate this description. The three are bound together in a web of political, economic and security relationships that have increased in complexity as a function of evolution in their respective economies and world events.

Table 2-10 below provides a simplified graphic representation of the main economic relationships between the Republic of Korea, Japan and the United States.

Table 2-10. Economic Relationships. (After Kang, 1989)

For -- \ -- is \	Republic of Korea	Japan	United States
Republic of Korea	-----	Market Supplier of Technology	Market Supplier of Technology Source of Capital (lender)
Japan	Market Subcontractor	-----	Market Supplier of Technology Borrower of Capital
United States	Subcontractor Market Borrower of Capital	Supplier of Technology Supplier of Components, Products and Equipment Market Lender of Capital	-----

All three are engaged in multiple relationships. A typical example is found in the automotive industry: major manufacturers -- Kia (Korea), Ford (United States) and Mazda (Japan) -- have a three-way partnership in which Mazda designs, Kia manufactures and Ford sells low-end, market-creating vehicles. In vendor-supplier relations, two-way partnerships often enter three-way relations. For instance, the Goldstar color television plant in Alabama could not get enough television tubes from Korea so it considered buying the parts from Toshiba Westinghouse -- a competitor at the end-product level.

Internationally -- particularly since the end of the Cold War -- emphasis has shifted from military to economic strength as a symbol of power and means of achieving peace and stability. Technological advances have made integration essential to the economic well-being of advanced and developing countries. In today's world it seems that no country can be totally self-sufficient. Efforts toward this end generally appear motivated by a desire to protect against possible breakages in dependency. However, they often lead to new dependency relationships that carry implications for foreign and domestic policy. For example, acquisition of new technology -- commonly viewed as a key to achieving self-sufficiency -- is often linked to direct foreign investment. Foreign investors develop interests

in the local economy that would be harmed by protectionism at home or any other deterioration of economic relations between the countries. Firms in both countries become "hostages" of the relationship and are thus inclined to act as moderating influences on their respective governments.

Such increasing complexity in relationships has led the South Korean government to reduce its direct economic involvement since the early 1980s. The Fifth Economic Plan, which came into effect in 1982, ". . . was to be devoted to reducing government involvement in the economy and so creating the conditions for a 'second take-off' into high and stable growth rates." (Mitchell, 1988) Current President Kim Young Sam's reforms and policies show a strong dedication to these goals.

### **3. Loans, Trade, Investment and Technology**

The Republic of Korea has continued to receive substantial amounts of money in development assistance loans from the United States and Japan. As Table 2-11 below shows, contributions from both more than doubled between 1980-91.

Table 2-11. Official Development Assistance from the United States and Japan (millions of U.S. dollars). (After *Development Co-Operation*, 1992)

	1980-1981	1990-1991
Total U.S. ODA (cumulative)	6,973	15,984
Total Japan ODA (cumulative)	3,592	10,462
% Total U.S. disbursements	0.6	-----
% Total Japan disbursements	6.9	2.3

Trading relationships among the three countries are evolving. As shown in Tables 2-12 and 2-13 below, the United States has continued to absorb more of South Korea's

exports while Japan provided more of its imports. However, comparative advantage in specific sectors is shifting: the United States has lost ground in merchandise trade, while Japan has gained a competitive edge in many industries; the Republic of Korea is following in Japan's footsteps at some distance, with manufactured goods dominating its exports (see Table 2-14 below). The nature of economic influence among the three is becoming more complex and is moving toward greater interdependence.

Table 2-12. Exports to the Japan and the United States (millions of U.S. dollars/percentage of total). (After *The Far East and Australasia, World Development Report* and *The Summary Report: Trade of Japan*, various)

	1980	1985	1990	1991	1992	1993
Total exports	17,505	30,283	65,016	71,900	76,800	82,235
To Japan	3,093	4,543	12,637	12,399	11,557	11,564
To the U.S.	4,607	10,754	19,360	18,559	18,090	18,138
Japan%	17.4	15.0	19.4	17.3	15.1	14.1
U.S. %	26.3	35.5	29.8	25.8	23.6	22.1

Table 2-13. Imports from the United States and Japan (millions of U.S. dollars/percentage of total). (After *The Far East and Australasia, World Development Report* and *The Summary Report: Trade of Japan*, various)

	1980	1985	1990	1991	1992	1993
Total imports	22,292	31,136	69,843	81,600	81,700	83,800
From U.S.	4,890	6,489	16,912	18,893	18,287	17,928
From Japan	5,858	7,560	18,574	21,120	19,458	20,016
U.S. %	21.9	20.8	24.2	23.2	22.4	21.4
Japan %	26.3	24.2	26.6	25.9	23.8	23.9

Table 2-14. Percentage Shares of Merchandise Exports. (After Steinberg, 1990 and *World Development Report*, various)

	Fuels, Minerals and Metals	Other Primary Commodities	Textiles and Clothing	Machinery and Transportation Equipment	Other Manufactures
1981	2	8	30	22	38
1987	2	5	25	33	59
1991	3	4	21	38	55

Although the United States and Japan remain its largest trading partners, the Republic of Korea has sought to diversify trade in recent years. Exports have increased to Hong Kong, Canada, Germany, Saudi Arabia, the United Kingdom and many other European, Middle Eastern, Asian, African and Latin American countries. Similarly, increased imports from a like distribution -- especially the oil-exporting countries -- have served to lessen South Korean dependence upon the United States and Japan. Adoption of its *nordpolitik* approach to improve relations with Communist countries in the late 1980s brought additional avenues of trade: between 1985 and 1988 total trade with Communist countries rose from \$1.4 billion

to \$3.7 billion (Macdonald, 1990). Whatever the number or character of its partners, South Korea's dependence on foreign trade makes it vulnerable to fluctuations in the international market. Such fluctuations tend to drive the country's economic cycles.

Japan's continuing trade surplus with both the Republic of Korea and the United States has been a major topic of concern in all three countries. Korean complaints include discriminatory import duties -- Korean imports are taxed at an average rate of 9 percent, where the average for all imports is 3 percent -- and an illiberal market in product categories in which Korean products are competitive. American complaints follow a similar line, focusing on the perception of a relatively "closed" atmosphere in the Japanese market. But dependencies of both complainants on Japanese goods, components -- and possibly even investment capital -- leave little room for either to take rigorous action. The resulting situation has been described as essentially ". . . a nonmilitary version of MAD (mutually assured destruction) if one side does anything extreme." (Kang, 1989)

United States-South Korean trade relations are beginning to resemble those between the United States and Japan. Disputes center on American complaints of South Korean nontariff trade barriers in agricultural goods, computer software and telecommunications equipment. A recent *Wall Street Journal* report suggests that the disagreements could end in sanctions under United States trade law:

A public row over trade will do little to help Korea's bid to join the Organization for Economic Cooperation and Development. . . . It would also perpetuate Korea's reputation as an unpredictable business partner, a situation that has discouraged many multinationals from investing in the country. (Glain, February 6, 1995)

Japan and the United States have also remained South Korea's primary investors, with cumulative direct investments in 1990 totaling more than \$4.3 billion and \$2.1 billion, respectively (*U.S.-Asia Economic Relations*, 1993 and *Global Economic and Technological Change*, 1993). Foreign investment in the Republic of Korea is governed by the Foreign Capital Inducement Law and subordinate regulations. Sectors of the economy where

investment is restricted or prohibited are classified in a negative list system. Despite easing of restrictions, 62 percent of foreign investment projects involved foreign equity of 50 percent or less, and wholly foreign-owned businesses only amounted to 24 percent of total projects by the end of 1991 (*International Business Practices: Republic of Korea*, 1993). The ceiling on foreign ownership in single stocks was recently raised from 10 percent to 12 percent, with plans to for an additional raise of up to 15 percent during 1995 (Nakarmi and Warner, 1994). Still, investing in South Korean stocks is not easy for foreigners: they must open accounts in the country and pay proxy, custodial and legal fees.

The Republic of Korea is aggressively accumulating new technology through trade and official partnering. Corporations in the Lucky Goldstar Group produce consumer electronics, semiconductors, liquid-crystal displays, computer software and memory chips through partnerships with predominantly Japanese and American companies. Samsung Group members are engaged in electronics, chemicals and heavy machinery enterprises with predominantly American and Japanese partners, and are now moving to enter the personal computer, automotive, aerospace, transportation and entertainment businesses.

Although the South Koreans have successfully graduated from manufacturing black-and-white televisions to high-tech color televisions and VCRs, they have a significant Achilles heel: a large portion of their final product content is Japanese. For example, close to 70 percent of the parts for VCRs come from Japan. As Kang (1989) wrote: "Open a Korean VCR, and one finds Matsushita, Toshiba, and other brands." In the course of development, many South Korean industries set up a greatly assembly-intensive structure and let parts fabrication expertise lag behind. Products are assembled from purchased parts and then exported to third countries. With such a structure, production of more exports means import of more parts. Dependence on Japanese components increases South Korean vulnerability to changes in trade and exchange rates, as well as technological advances -- and most current advances in consumer electronics are being made at the component level.

A major complaint of South Korea's high-tech industries is that the Japanese are becoming more closed with their new technology. The Japanese cite lack of intellectual property protection as a reason for withholding state-of-the-art technology. They also seem particularly concerned about what they call the "boomerang effect," under which technology transferred to the Republic of Korea and other newly industrializing countries will ". . . come back to haunt them in their home and third-country markets." (Kang, 1989) Pohang Steel is continually cited by the Japanese as an illustration of this phenomenon. South Korean reaction to this is that Japan: (1) cannot and should not try to hold on to all market sectors, and (2) as a maturing economy, should focus on more high-end products and leave the low- and more of the medium-end products for other countries to exploit.

Despite its complaints, conditions have often proved favorable to South Korea. For example, rapid appreciation of the yen in 1986-87 sent many small-to-medium Japanese enterprises flocking to South Korean subcontractors to stay afloat. This has had a particularly strong impact on the Japanese electronics industry. By the end of the 1980s one electronics trade paper in Japan estimated that ". . . 70 percent of the radiocassettes sold in Akihabara -- the electronics retail district in Tokyo -- even under Japanese brand names, are made in the newly industrializing economies; perhaps fully half of them are Korean." (Kang, 1989)

#### **4. Regional Security**

Possible aggression from North Korea, political and economic instability in the former Soviet Union, strengthening of China's military capabilities and territorial disputes are just a few of the regional security concerns shared by the Republic of Korea, United States and Japan. There is no single defensive alliance with a common aim in the Pacific region -- only

alliances through bilateral treaties and non-allied "security partners"<sup>7</sup> who share common interests but may not always agree on security matters. Economic and political relations have improved between the Communist, ex-Communist and non-Communist countries since the mid-1980s, but tensions continue and the United States remains the "arbiter and stabilizer of choice" within the region. Although the complete definition of "security" includes economic, political, cultural and other elements, this section will focus on defense matters.

By far the most immediate threat to East Asian peace and stability is the situation on the Korean peninsula. North Korea poses a visible threat to the south, deploying nearly a million soldiers along the demilitarized zone; its *No Dong* 2 ballistic missile threatens the Japanese. North Korean obstruction of a March 1994 nuclear facility inspection by the International Atomic Energy Agency (IAEA) focused attention on its ability to produce nuclear weapons and brought the possibility of armed conflict nearer to becoming reality. Commenting on the situation in a *TIME* magazine interview conducted one week after the incident, South Korean President Kim Young Sam said:

It is difficult to deal with North Korea patiently, but I think time is on our side. Even if North Korea can develop nuclear weapons clandestinely, that route will lead to its self-destruction. The most important thing in all of this is to persuade North Korea to open its doors and participate in the international community. (*TIME*, March 28, 1994)

South Korea, the United States and Japan have since conducted negotiations with the north to alleviate the crisis and better relations. They have also formed an international consortium -- the Korean Peninsula Energy Development Organization (KEDO) -- to finance the terms of the "framework" agreement reached between the United States and North Korea. North Korea is to receive new light-water nuclear reactors and nearly \$500 million in alternate energy supplies in return for the freeze and eventual dismantlement of its nuclear program. However, many details remain unresolved. Disagreement over the specifications

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<sup>7</sup>A phrase used by RADM (retired) James A. Winnefeld of the RAND Corporation in his testimony before the Subcommittee on Asian and Pacific Affairs of the Committee on Foreign Affairs, House of Representatives on 31 January 1990.

of the reactors was a major hurdle that stalled progress for more than three months. The consortium preferred reactors compatible with those in South Korea: this would ease integration after reunification -- a stated goal of both Koreas. But the north said that any such plans could jeopardize the deal. Following a marathon round of negotiations with the United States in June 1995, North Korea consented to the inclusion of a clause in the "framework" agreement stating that "KEDO shall select a reference power plant for North Korea." However, the potential for conflict over the issue of South Korean reactors remains. The North Korean spokesman, Vice Foreign Minister Kim Gye Gwan, was careful not to mention South Korea in any of his statements. He would only say that the north is prepared to "sincerely implement" the Geneva accord "as in the past," and that more difficult tasks remain to be settled. (Johnson, 1995)

American military presence on the Korean peninsula has traditionally been linked to: (1) deterrence of aggression (north and south), (2) avoidance of hegemony, (3) an "umbrella" for economic expansion in the south, (4) tangible assurance of support for the south's peaceful initiatives toward the north, and (5) symbolic representation of the United States' interest in regional stability, particularly concerning Japan. Japan's past behavior is still a source of concern among its Asian neighbors. Even among its own citizens, a feeling that Japan cannot be trusted as an independent military power permeates the region. The idea of a collective security approach to defense is gaining popularity throughout East Asia. Because of its economic preeminence, Japan is expected and encouraged to increase its participation in regional security matters -- but contributions in nonmilitary areas are preferred.

## **D. CONCLUSIONS - LOOKING AHEAD**

### **1. Comparative Influence of the United States and Japan**

Economically and politically the United States and Japan have played equally crucial roles in the Republic of Korea's development. Both have displayed a continuing determination to ensure its independence and growth. Influence has been mostly shared, but divided in terms of time or category. Japan has clearly been the leading investor. American commitments include strong military ties that Japan cannot legally develop. In trade, their roles are roughly equal; in quantity of aid and technology transfers the lead has clearly shifted from the United States to Japan.

Culturally, Japan's influence reaches much farther into the society than the South Koreans care to admit. Basic structures definitely resemble the "Japanese model": similarities in the government's ministerial structure and the banking, judicial, and educational systems are too profound to be chance; many can be traced to the Japanese colonial system. The Republic of Korea is the only newly industrialized economy in East Asia that has patterned its economic development largely on methods used by Japan over the last 30 years. Today's competitive South Korean products are very similar to those Japan used to become a major economic power: steel, cars, consumer electronics, and more recently, semiconductors.

### **2. A New Triangle - Where from Here?**

Japan was the "adolescent" in for many years, enjoying American assistance and tolerance. Now, Japan has "grown up" and the Republic of Korea is a fast maturing "adolescent" who wants similar treatment from its successful neighbor. It is to Japan what Japan was to the United States: South Korean industries are penetrating the Japanese market

in the same manner Japanese industries penetrated the American market. Economically, protégés are becoming partners; partners are becoming competitors.

South Korean and Japanese armed forces are oriented toward defense rather than offense. Even so, both can deploy a substantial military force and produce a wide range of advanced conventional and nuclear weapons systems -- factors that contribute to continued feelings of mutual distrust and apprehension. Although the two have made progress toward cooperation on mutual defense issues they still have no direct military ties -- only indirect linkages through their mutual ally, the United States. South Korea considers its military strength essential to Japan's security, but will not accept Japanese military forces as a factor in its own. Japan's "Peace Constitution" will continue to restrain that country's military. Both view an American presence as vital to regional security.

Old wounds are still healing. Many Koreans, Japanese and Americans remember the Japanese occupation and World War II firsthand: it is difficult for them to fully trust each other. Retirement and the passing of that generation -- many of whom are still in top management -- may help to clear the way for a greater sense of trust and unity among the three nations.

America's size, strength and global responsibilities demand a responsible role in the Asia-Pacific community. Although declining in relative economic position within the region, the United States is rising in absolute terms. It is still widely perceived as the key to maintenance of world peace and stability and serves as a model for democracy and the promotion of human rights. Japan's economic strength also demands increased responsibility. Shared leadership between the United States and Japan has been repeatedly declared as desired by all -- and is gradually being realized. South Korea's rapid ascent signals a similar situation, possibly within the next two generations.



### III. THE PEOPLE'S REPUBLIC OF CHINA: CASE STUDY

#### A. BACKGROUND: THE NEW COMMAND ECONOMY - THE 1950s AND '60s

##### 1. After the Civil War

When the People's Republic of China was proclaimed in 1949, much of China's infrastructure, industry and agriculture had been damaged or destroyed. The war with Japan, Soviet occupation and civil war had claimed half its rail system, locomotives and fishing fleet, and more than half the capital stock in its main industrial areas in the northeast.<sup>8</sup> Chronic shortages of raw materials -- aggravated by Nationalist blockades -- further impaired industrial output. Most of China's communication and power systems had been destroyed or were badly deteriorating from lack of maintenance. Food production had fallen to 30 percent of prewar peak levels, exacerbated by severe flooding in 1949 (*Army Area Handbook*, 1988). Inflation was out of control.

The new Communist regime faced a monumental task in salvaging the Chinese economy. Its immediate concerns were the restoration and rehabilitation of agriculture, industrial plants and transportation systems. Foreign aid, primarily from the Soviet Union, would be critical to economic development over time, but immediate survival and recovery depended upon elements found within China itself.

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<sup>8</sup>Following the defeat of Japan in 1945 the Soviets dismantled over half Manchuria's industrial machinery and sent some of it to the Soviet Union.

## **2. Foundations for Recovery and Growth**

Human capital was perhaps the most valuable asset the new People's Republic inherited. Centuries of Confucian tradition had produced a moderately literate population with a small but significant number of highly educated elites. By the early 1940s there were many experienced, well-trained Chinese workers and managers in the country's modern commerce, industrial and transportation sectors. Together the educated elites and modern-trained work force formed the core of China's human rehabilitative resources.

In material terms, the People's Republic inherited the remnants of a large quantity of unevenly distributed but relatively modern industry and infrastructure. This included light consumer goods industries and commercial activities centered around the old treaty ports, and heavy industries based in Manchuria -- along with all associated organizations, ancillary services and infrastructure. A century of foreign "intrusion" had enabled China to progress toward modernization in many sectors by the early 1940s. The most advanced development had occurred in Manchuria as the result of Imperialist Japanese efforts between 1931-43. "At the end of this period, Manchuria, with only about one-tenth of the mainland area, had one-third of mainland railway mileage, 40 percent of its coal production, close to 70 percent of its power capacity, more than 70 percent of its cement, 85 percent of its pig iron, and more than 90 percent of its steel production." (Eckstein, 1966) Although much had been damaged or destroyed by 1949, the material foundations for growth remained, ready for rehabilitation and development.

## **3. Marriage to the Soviet Union**

In April 1949 Mao Zedong announced that China would "lean" to the side of the socialists. Formal economic relations were established between the Chinese Communists and the rest of the Communist world in July 1949 -- three months before the establishment of the

People's Republic -- in a barter agreement with the Soviet Union. Hoping to negotiate Soviet assistance in developing China's economy along socialist lines, Mao visited Moscow the following December. A thirty-year treaty of friendship, alliance and mutual assistance was signed in February of 1950. From this "marriage" China was to receive well over \$700 million in development loans and low-interest credit, military loans and assistance, the return of Soviet-held rail, port and shipbuilding facilities in Manchuria, and the installation of 291 turnkey projects<sup>9</sup> by 1960. Also during this period more than 11,000 Soviet and East European specialists and technicians were sent to China to provide training and assistance, while some 38,000 Chinese engineers, skilled workers and students went to the Soviet Union for advanced training. (*Army Area Handbook*, 1988) Soviet assistance to China during the 1950s was perhaps the most extensive one-way transfer of technology in the twentieth century.

Alliance with the Soviet Union and participation in the Korean War separated China from most non-Communist countries politically and economically in the early 1950s. By 1949 Communist and non-Communist global spheres of influence were beginning to develop: formed in 1948, NATO and its allies were already starting to set strategic controls over trade with the European Communist countries. Many non-Communist countries -- particularly the United States<sup>10</sup> and Japan -- still recognized or supported the Nationalist Chinese government "in exile" on Taiwan. The United States embargoed all trade with Communist China after the outbreak of the Korean War. NATO<sup>11</sup>, Japan and many others quickly followed suit with varying degrees of severity. In 1951 the United Nations declared the People's Republic an

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<sup>9</sup>A variety of entire modern industrial operations such as steel mills, electric power, chemical, machine-tool, aircraft and electronic plants were transferred, complete with their plans, technology and extensive Soviet technical assistance.

<sup>10</sup>By 1948-49 anti-Communist sentiments were intensifying and beginning to drive foreign policy in the United States. America began turning away from all Communists, regardless of nationality or previous affiliations.

<sup>11</sup>Except Iceland.

aggressor in Korea and sanctioned a global embargo on arms and war materiel shipments to China. These events also meant that China had become separated from potential resources for economic development. The situation was best summed up by Tsao (1987):

Because of a lack of experience in both economic planning and advanced technology, Chinese leaders had to rely heavily on foreign aid for their economic development. At that time the Soviet Union was the only country that was willing and able to provide China with economic and technical assistance. ...Chairman Mao adopted the Soviet model...despite whether the model was well suited to the Chinese economy.

#### **4. Recovery and Growth**

Under the leadership of Chairman Mao Zedong and Premier Zhou Enlai, the Communist government declared the period 1949-52 a time of rebuilding and recovery. Intensive economic growth and long term development were to start with the execution of the Soviet-styled First Five-Year Plan between 1953-57. The Plan called for "...high rates of savings and investment (or *capital construction* in Chinese terminology); collectivization of agriculture; heavy emphasis on the development of those industries producing raw materials and investment goods; reliance on large-scale and capital-intensive technology in industry; and relative neglect of investment in agriculture, consumer goods industries, and social overhead." (Tsao, 1987) China was to undergo social as well as economic reconstruction.

The new regime moved quickly during the recovery phase to take control of the economy and curb inflation. It used a variety of measures: banking was nationalized and centralized, the monetary system unified, currency value guaranteed, credit tightened, savings and sales campaigns initiated, the tax system reorganized, and government spending placed under central control and restricted. State trading companies were established to stimulate and regulate commerce. Effective systems of rationing and food stores were set up in the

mid-1950s to ensure that sufficient quantities of basic necessities<sup>12</sup> would be available to everyone during good and bad times.

Extensive land reform was undertaken to revive the agricultural sector and feed an estimated population of 540 million. First, about 45 percent of China's arable land was expropriated from landlords and more prosperous farmers and redistributed to the 60 or 70 percent of tenant farmers and landless workers (*Army Area Handbook*, 1988). Redistribution was not a particularly benign procedure; as many as two million landlords were reported to have lost their lives in the process, while many others were "reformed" through a hard-labor program. Next, all farmers were "encouraged" to participate in "mutual aid teams" -- units of six or seven families -- to pool their labor in exchange for a percentage of the net return based on workday units. "Mutual aid teams" soon evolved into "agricultural producers' cooperatives" in which land use was determined collectively and both land and labor were pooled for a proportional return. The government gradually pressured the land share portion of the return to zero, transforming the "agricultural producers' cooperatives" into truly collective ventures. Each cooperative grew to encompass most or all of a farming village. Everyone worked for wages; material contributions of land, livestock or machinery had no effect on income. By 1957 the cooperatives had spread rapidly, with approximately 93.5 percent of China's farm households participating (*Army Area Handbook*, 1988).

Land reform between 1949-57 helped to equalize income distribution and increase agricultural productivity. Official Chinese statistics show that rice production in 1952 exceeded pre-1949 peak levels by 11.1 million tons. The area of cultivated land increased by more than 10 percent between 1949-52. Although the First Five-Year Plan allocated only 7.6 percent of investment to agriculture -- which included forestry and water conservation -- the gross value of agricultural production grew at a rate of 4.5 percent between 1953-57. (Tsao, 1987)

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<sup>12</sup>Mainly foodstuffs and material for clothing.

The new regime also embarked upon a major restructuring of the industrial sector. In 1949 approximately 63 percent of all industry was privately owned, 2 percent under joint private-state ownership and 35 percent wholly owned by the state (King, 1968). Much of the modernized transportation sector was also under state control. The new Communist government took over the Nationalist enterprises and confiscated the property of "bureaucratic capitalists." Its ultimate political goal was to place the means of production under public ownership. However, the shift had to occur slowly -- at least initially -- because the talents of the experienced non-Communist managers, technicians and administrators were needed to keep the modern sectors running. Financial pressures such as high taxes and forced wage agreements were used to induce retirements and the sale<sup>13</sup> or conversion of property to joint ownership with the state. Small handicraft industries were organized into cooperatives; these employed more than 91 percent of China's handicraft workers by 1956 (*Army Area Handbook*, 1988). By 1957 private enterprise was eradicated: approximately 68 percent of all industry was state owned, the remaining 32 percent under joint private-state ownership (King, 1968).

Industrial rehabilitation and development were pursued simultaneously in the large-scale, capital-intensive and small-scale, labor-intensive sectors. Key industries such as iron and steel manufacturing, electric power generation, coal mining, and cement, chemical and machine production -- those mostly linked with military potential -- were targeted for expansion and modernization. Bank loans were made readily available for industrial development. Under the First Five-Year Plan, 58.1 percent of total investment was allocated to industry (Tsao, 1987). About half this investment went to 156 large-scale, capital-intensive heavy industry projects designed with Soviet assistance (Fairbank, 1992). Predictably, industry grew much faster than agriculture. Between 1953-57 the gross value of industrial

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<sup>13</sup>Many foreigners were forced to sell out just to pay taxes.

production grew at an average annual rate of 18 percent (Tsao, 1987). Large-scale industry grew faster than small-scale industry.

The government set ambitious production targets for industry and agriculture which were generally exceeded. Socialist economic organization removed many production constraints and assured sales at cost-plus prices. Output in the machinery production sector was particularly striking: in 1957 it surpassed the planned level by more than 80 percent (Perkins, 1975). Performance in other sectors was also impressive, as shown in Table 3-1.

Table 3-1. Outputs and Annual Growth Rates of Selected Products (After Tsao, 1987).

	1953 Actual Output	1957 Planned Output	1957 Actual Output	1953-1957 Annual Growth Rate (percentages)
Steel (million tons)	1.774	4.120	5.350	31.8
Pig iron (million tons)	2.234	---	5.936	27.7
Coal (million tons)	69.680	113.000	130.000	16.9
Electric power (million kWh)	9,200	15,900	19,340	20.4
Crude oil (thousand tons)	622	---	1,458	23.7
Chemical fertilizers (thousand tons)	226	---	631	29.3
Cement (thousand tons)	3,880	6,000	6,860	15.3
Grain (million tons)	166.83	226.73	195.05	4.0
Cotton (thousand tons)	1,174.50	2,050.25	1,640.00	4.7

Agricultural production remained the dominant sector of China's net domestic product through the First Five-Year Plan. However, its share -- and the shares of other "traditional" sectors -- declined, while those of the "modern" sectors increased, as illustrated in Table 3-2.

Table 3-2. Percentage Shares of China's Net Domestic Product by Industrial Origin.  
(After Eckstein, 1966)

	1952	1955	1957
Agriculture	47.9	44.7	40
Large-scale Industry	11.5	15.7	20.4
Small-scale Industry	6.6	6.1	5.5
Construction	2.5	3.5	4.7
Modern Transportation	2.9	3.7	3.9
Traditional Transportation	3.7	2.8	2.5

China's recovery and growth during this period were hastened by the availability of transportation. The government had invested heavily in railroad reconstruction early on; by mid-1951 all the old lines were restored and much new construction was underway. Good rail connections meant that raw and intermediate materials could be transferred quickly and easily between coastal and inland cities.

Urbanization also accelerated during the early and mid-1950s as industrial expansion generated more employment opportunities, but China's population remained predominantly rural. Although it had increased by about 30 percent since 1952, urban dwellers accounted for only 14 percent of the total population in 1957 (Eckstein, 1966).

The Chinese government viewed trade both as an engine of growth and a political tool. Imports of raw materials and advanced machinery were needed -- especially during the 1950s -- to achieve rapid industrialization and growth. Chairman Mao's "lean to one side" policy and the embargoes of non-Communist countries forced the bulk of China's trade to be

with the Soviet bloc. "According to the First Five-Year Plan, the three main goals of foreign trade were to (1) strengthen economic cooperation with the socialist bloc headed by the Soviet Union, (2) expand China-Soviet bilateral trade, and (3) steadily increase the volume of trade with Communist countries other than the Soviet Union." (Tsao, 1987) Trade with other Asian (non-Communist) countries was also allowed under the Plan if conducted in a manner consistent with China's foreign policy.<sup>14</sup>

However, the direction of China's trade was affected by politics and diplomacy as much as -- if not more than -- pure economic necessity during the 1950s. China's trade was roughly divided two-thirds with the Soviet bloc, one-third with the West and Asia (Kleinberg, 1990). The Soviet Union dominated as the number one partner, followed by Hong Kong. Bilateral trade with these two partners accounted for 47.8 and 9.6 percent, respectively, of China's total trade between 1950-59. In contrast, trade with Japan amounted to only 1.9 percent during the same period<sup>15</sup>; that with the United States rapidly decreased from \$238 million in 1950 to \$0.2 million in 1953 and was completely halted by 1954 because of the embargo (see Table 3-3 below). (Tsao, 1987)

China exported consumer goods -- agricultural, mineral and handicraft products -- and imported producer and capital goods -- primarily modern machinery and equipment. Shifts in the composition of its exports indicated the effectiveness of the government's recovery and

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<sup>14</sup>Chairman Mao literally defined the country's policies. At the time his attitude toward foreign trade was more pragmatic than ideological, as revealed in his remarks at the Second Session of the Seventh Central Committee of the Chinese Communist Party in March 1949: "[W]herever there is business to do, we shall do it. ... So far as possible, we must first of all trade with the socialist and people's democratic countries; at the same time we will also trade with capitalist countries." (Lee, 1976)

<sup>15</sup>Economic relations were officially established between Japan and the People's Republic in 1950, although "unofficial" trade had resumed in 1949. Japan was bound by the UN Coordinating Committee (COCOM) and NATO China Committee (CHINCOM) controls on exports to Communist China in 1952 -- the year bilateral trade between them reached its lowest point. After the Korean Armistice, Japan began relaxation of restrictions on embargoed items by using CHINCOM's special "exceptions" procedures and applying the same restrictions placed on the Soviet Union and Eastern Europe to China. Economic relations were effectively severed by China in 1958 as a political reaction to an incident: a Japanese youth tore down a People's Republic flag from a Chinese stamp exhibit show in a Nagasaki, Japan department store.

industrialization efforts. For example: unprocessed agricultural goods made up 55.7 percent of China's exports in 1953; by 1957 their share had declined to 40.1 percent. Meanwhile, light industrial and textile exports increased by 240 percent between 1953-59. (Kleinberg, 1990) Imports and exports more than doubled during the 1950s, with imports growing at a faster rate until about 1954. Up to that point a large portion of imports had been financed with Soviet loans. The Soviet loans began to amortize in 1955; Chinese exports were expanded significantly faster than imports to help pay off the debt. (Eckstein, 1966)

Table 3-3. Total Value of China's Trade with Selected Countries  
(millions of US dollars). (After Kleinberg, 1990)

	1950	1955	1960
Soviet Union	338.4	1,789.8	1,663.9
Hong Kong	151.2	189.4	208.3
Japan	47.2	83.3	0.2
United States	238.1	0	0

The First Five-Year Plan was largely a success. National income and gross social product<sup>16</sup> averaged annual growth rates of 8.9 and 11.3 percent, respectively, and the gross value of industrial and agricultural production averaged 10.9 percent (Tsao, 1987). However, despite the Chinese economy's rapid recovery and growth, per capita income in 1957 was only about 20 percent higher than it had been in 1933. With per capita income that year between \$70-80 China placed among the poorest of developing countries (Perkins, 1975). Employment had only grown about 1.5 percent annually (King, 1968). An increasing imbalance between agricultural and industrial growth and the negative effects of uncontrolled

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<sup>16</sup>Tsao (1987) defines gross social product as the sum total in value of a year's gross output in industry, agriculture, construction, transport and commerce (including the catering trades and materials supply and marketing ventures). He defines national income as the newly created value of material production within a given period, calculated by deducting the material consumption of the agriculture, industry, construction, transport and commerce sectors from the gross social product.

industrial output maximization -- such as poor quality, high costs and excess capacity -- were proving that the Soviet development model was not appropriate for China. Relations between the People's Republic and the Soviet Union were souring rapidly as the result of differences in ideological interpretations and mutual dissatisfaction over trade practices and finance agreements. Policy changes were inevitable.

## 5. The Great Leap Forward (?) and Divorce from the U.S.S.R.

In 1958 China's government shifted to a more radical approach to economic development. Three highly ideological movements, the "General Line for Socialist Construction," "Great Leap Forward of Production," and "People's Commune Movement" -- together called the "Three Red Banners" -- were initiated under the direction of Mao Zedong. In the words of Perkins (1986):

Mao's messianic vision for China was driven by values many of which had little to do with economics, but in 1958 and 1959, at least, that vision included the belief that China could find a new and faster way to achieve economic development and the creation of a Communist society. That vision was inspired by neither the Soviet Union nor the rest of East Asia, but by Mao's own experience with attaining seemingly unreachable goals through mobilization of the masses.

The "General Line" simply amounted to a set of four "inspirational" party slogans<sup>17</sup>; the "Great Leap" and "Commune Movement" were programs intended to produce extremely rapid, simultaneous growth in agriculture and industry and begin the country's conversion from Socialism to "true" Communism.

The Chinese government sought decentralization and collectivization in industry and agriculture. These goals were relatively easy to achieve in agriculture; groups of 20-30 "agricultural producers' cooperatives" were reorganized into communes. The communes

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<sup>17</sup>"Abundance," "speed," "goodness" and "economizing."

functioned both as productive units and local governments. Besides agriculture they were made responsible for planning and managing local industry, trade, taxation, education and military affairs. They took over the small private plots of land held by farmers. Members were often required to live in communal quarters, dine in public mess halls and send their children to communal nurseries. More than 8,700 communes had been organized by late 1958, with participation of farm families at more than 99 percent (Tsao, 1987).

Control of the industrial sector was largely delegated to the provincial and local governments. Direction of many enterprises was taken over by groups of unqualified but politically "inspired" Communist Party members. The liturgy of the "Great Leap" stressed management by inspiration and spontaneity rather than careful planning. Managers were to identify and creatively use idle productive capacity -- machinery and labor -- to push output beyond levels previously considered possible. Ill-prepared "surplus" rural labor and cadres of city dwellers<sup>18</sup> were mobilized to support industry and create capital in the agricultural sector. Scores of these unskilled laborers were tasked with completing vast public works projects in irrigation and water control and setting up local small-scale industries. More than 700,000 small "backyard" steel furnaces -- which employed outdated technology -- were set up in 1958; the nonprofessional steelworkers who ran them made up 18.8 percent of the country's total labor force (Tsao, 1987).

Government-set production targets were unreasonably high in all sectors. Along with the problems created by widespread use of unqualified and unskilled labor this contributed to general mismanagement, overwork, poor quality and false reporting. The initiatives of the "Great Leap" achieved exactly the opposite of what was intended. Agricultural production suffered many hindrances. The shift to communal living was not well received by many because it ran contrary to the strongly family-oriented traditional Chinese lifestyle. Work slowdowns, slaughter of livestock and damage to public property were common expressions

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<sup>18</sup>These people were sent as a part of the *xiaofang* (down to the countryside) movement to participate in manual labor projects and gain firsthand familiarization with grassroots conditions.

of resentment. Many who were sent out to public works projects were unable to return in time to complete essential farming tasks. Adverse weather in 1959-60 further complicated matters: agricultural production dropped by more than 13 percent and famine became widespread (*Army Area Handbook*, 1988). The resulting loss of life was estimated at 20-30 million (Fairbank, 1992).

General inefficiency and mismanagement of the whole production cycle also resulted in shortages of raw materials and deterioration of industrial plants. Sudden withdrawal of Soviet economic and technical aid in 1960 canceled or left major investment projects<sup>19</sup> unfinished. The extent to which the People's Republic had become dependent upon the Soviet Union over the past decade became painfully obvious. In combination with the detrimental effects of the communes and the "Great Leap," the Soviet pullout caused China's industrial output to decrease by 38 percent in 1961 (*Army Area Handbook*, 1988).

## 6. Readjustment and Recovery

The chaotic condition of China's economy in 1960 called for drastic action. To avoid further disaster from the agricultural crisis the government canceled nearly all orders for technical imports and redirected its foreign exchange reserves to purchase imports of grain. Reduced productive output in all sectors severely limited China's export potential and purchasing power; trade was curtailed to prevent development of a large deficit.

Responding to growing criticism at home and abroad Mao resigned the presidency of the People's Republic, and the more pragmatic Liu Shaoqi was selected as his successor. Although Mao retained his position as its Chairman, the Chinese Communist Party was dominated by more moderate leaders such as Liu, Deng Xiaoping, and Chen Yun.

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<sup>19</sup>One of the terminated projects was a 1957 agreement to help China produce its own nuclear weapons and missiles.

The “Great Leap” was officially abandoned in 1961. Four guidelines for recovery were formulated: (1) “adjustment,” or reordering sectoral priorities so that industry would be used to develop agriculture and provide essential consumer goods<sup>20</sup>; (2) “consolidation,” in which communes were decentralized, their rules relaxed and small private plots were returned to farmers; (3) “enrichment,” or strengthening weak links between economic units and correcting false production reporting; and (4) “elevation” of production technology and product quality. Two specific sets of economic policy -- “The 60 Articles of the People’s Commune” and “The 70 Articles of Industry” -- were formed from the four guidelines.

Important changes under “The 60 Articles” included team ownership of the major means of production, the use of 7 percent of team land for private plots and an entitlement for farmers to sell their surplus goods in a free market (Tsao, 1987). Other government efforts to revive the agricultural sector included reduced taxes and increased prices for agricultural products.

A number of unproductive industrial enterprises were shut down in accordance with “The 70 Articles.” Shipment of defective or inferior products from producing units was banned. Although a few key enterprises were returned to central state control, the majority remained under provincial and local government command. Planning was “in,” output maximization “out.” The growth of many small-scale rural industries such as chemical fertilizer and agricultural machinery plants, coal mines and hydroelectric plants increased availability of badly needed commodities to the agricultural sector and helped to reverse the economy’s downward spiral.

Rural industries may also have helped to solve a growing unemployment problem made worse by factory closures. Rather than risk a problem with squatters’ villages and shanty towns or pay the cost of providing urban services to large numbers of unproductive residents, the government shipped millions of urban unemployed to the countryside. A strict

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<sup>20</sup>This is often referred to with the slogan “agriculture as the foundation and industry as the leading factor.”

program of registration and rationing severely limited migration and urban growth. People inherited their status as rural and urban dwellers. By 1965 China's urban population only amounted to 18 percent of the total (*World Development Report*, 1979).

Aftershocks of the "Great Leap" and initial retrenchment produced a considerable decline in agricultural and industrial production in 1961 and 1962. According to Eckstein (1966) the only exceptions were crude oil, chemicals and agricultural machinery. Signs of wholesale improvement were evident in 1963; production had effectively recovered by 1965. These trends are illustrated in Table 3-4.

Table 3-4. Actual and Estimated<sup>21</sup> Outputs of Selected Products (After Tsao, 1987).

	1957 Actual Output	1959 Estimated Output	1962 Estimated Output	1965 Estimated Output
Steel (million tons)	5.35	10.0	8.0	11.0
Coal (million tons)	130.0	300.0	180.0	220.0
Electric power (million kWh)	19,340	42,000	30,000	42,000
Crude oil (thousand tons)	1,458	3,700	5,000	8,000
Cement (thousand tons)	6,860	11,000	5,500	11,000
Grain (million tons)	195.05	165.0	75-180	190-195
Cotton (thousand tons)	1,640	1,600	900	1,500

<sup>21</sup>Chinese statistical data for 1958-59 is not completely reliable because of widespread reporting problems. The Communist government practically stopped reporting statistics after 1960; the Statistical Bureau ceased to operate between 1966-76 as a result of the Cultural Revolution (Eckstein, 1966 and Tsao, 1987). The estimates shown were originally published in *People's Republic of China: An Economic Assessment*, the Congress of the United States, Joint Economic Committee, May 18, 1972.

During this period of readjustment and recovery the government's focus on agriculture nearly evened growth between the agricultural and industrial sectors. However, industry maintained a slim lead. The average annual growth in agricultural output was 9.6 percent, while industrial output grew at an average of 10.6 percent between 1961-66 (*Army Area Handbook*, 1988).

After the Soviets withdrew in 1960, the People's Republic looked to Japan and the West for imports of advanced machines and technology necessary for economic development. Trade with Communist countries overall declined<sup>22</sup>, while trade with Western countries -- except the United States -- increased steadily. Bilateral trade with Western Europe and Canada accounted for about 20 percent of China's trade during the 1960s; China ran trade deficits with them all (Kleinberg, 1990). Hong Kong trade also continued its steady increase. Though not China's largest partner, Hong Kong was perhaps its most important one, serving as the principal source of China's foreign exchange and its go-between with the West.

In the fall of 1960 Premier Zhou Enlai presented his "Three Trading Principles" for Sino-Japanese trade: "(1) the conclusion of intergovernmental agreements is most desirable for resumption of Sino-Japanese trade; (2) pending such developments, China is willing to accept civilian trade agreements; and (3) China would trade with individual Japanese companies on the basis of special considerations." (Lee, 1976) This marked the beginning of "friendship trade" between the People's Republic and Japan. Politics still played an important part in China's economic relations: trade was first conducted with "friendly" Japanese private companies that agreed to Zhou's political<sup>23</sup> and trade principles. Most of these were small and economically weak, however, and could not satisfy China's growing

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<sup>22</sup>China's bilateral trade with Communist countries was roughly 41 percent less during the 1960s than in the previous decade (Kleinberg, 1990).

<sup>23</sup>In 1958 Zhou announced three political principles that would have to be followed if China and Japan were to resume economic relations following the incident in Nagasaki. He required that the government of Japan: "(1) not to adopt a policy inimical to China, (2) not to join a plot to recognize two Chinas, and (3) not to hamper attempts for normalization of Sino-Japanese relations." (Lee, 1976)

needs. The political requirements were soon relaxed to increase the number of Japanese partners. In 1962 the quasi-official memorandum, or "L-T" trade<sup>24</sup> was initiated to include the larger, more powerful Japanese companies that could provide the long-term credits, complete industrial plants and stable supply of industrial commodities China needed. The first complete plant -- a \$22 million synthetic textile plant -- was purchased from the Kurashiki Rayon Company in 1963 (Lee, 1976). A second synthetic textile plant was purchased in 1965 (Jain, 1977). Bilateral trade with Japan from 1963-65 amounted to more than \$4.9 billion, 10.7 percent of China's total (Tsao, 1987). As illustrated in Table 3-5 below, Japan became China's number one trading partner in 1965.

Trade with the Soviet Union continued, although at a severely reduced rate. It accounted for 11.7 percent of China's bilateral trade during the decade of the 1960s (Tsao, 1987). Part of this was undoubtedly trade to service China's debts -- mostly exports of commodities needed by the Soviet Union -- which were finally paid off in 1964. Sino-Soviet trade declined to only 1 percent of China's total by value in 1970 (Kleinberg, 1990).

Table 3-5. Total Value of China's Trade with Selected Countries (millions of US dollars). (After Kleinberg, 1990)

	1960	1965	1970
Soviet Union	1,663.9	407.4	47.2
Hong Kong	208.3	436.6	592.5
Japan	0.2	454.3	806.5
United States	0	0	0

Between 1963-65 China's national income and gross social product averaged annual growth rates of 14.7 and 15.5 percent, respectively; the gross value of industrial and

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<sup>24</sup>Short for "Liao-Takasaki," the names of the Chinese and Japanese representatives who negotiated the terms of the agreement.

agricultural production combined averaged 15.7 percent (Tsao, 1987). All these rates were higher than those achieved under the First Five-Year Plan. By 1965 the People's Republic had mostly recovered from the "Great Leap" -- economically.

Chairman Mao grew increasingly displeased with what he perceived as "capitalistic" tendencies in President Liu's economic policies. To "correct" the situation he launched the "Socialist Education Movement" in 1962. The movement primarily focused on ideological purity and revolutionary zeal; it included restructuring the school system to fit commune and factory work schedules so that everyone could participate in this work-study program. Party moderates -- Liu Shaoqi, Deng Xiaoping and others -- opposed the movement. Meanwhile, Mao was regaining his political strength, systematically recapturing control of the Communist Party. The "Socialist Education Movement" was soon reinforced by a campaign for citizens to "learn from the People's Liberation Army." (*Army Area Handbook*, 1988) The Communist Party was splitting; a major confrontation was inevitable.

## 7. Cultural Revolution: Taking a Step Backward

By mid-1965 the Chinese Communist Party was essentially divided into two main factions: the group of moderates led by Liu Shaoqi and Deng Xiaoping, and a Mao Zedong-Lin Biao clique that had gained control of the Party and the People's Liberation Army. Premier Zhou Enlai took neither side, but tried to intercede between them.<sup>25</sup> Mao's campaigns continued to gain momentum until they erupted, full-blown, as the "Great Proletarian and Cultural Revolution" in mid-1966.

For the first time, "revolutionary" forces were aimed against the Party itself. Fairbank (1992) summarized Mao's vision for the movement:

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<sup>25</sup>Zhou remained personally loyal to Mao throughout, though he did not always agree with the Chairman's policies -- especially during the Cultural Revolution.

Spiritual regeneration, as he put it, was to take precedence over economic development. The principle of class struggle was to be applied to all intellectuals, bureaucrats, and party members in order to weed out "those in authority taking the capitalist road.

Secondary school and university students from all over China were mobilized into militant gangs called the "Red Guards" with massive rallies in Beijing. Some 10 million teenagers attended, receiving free rail transportation and lodging (Fairbank, 1992). Slogans such as "Learn revolution by making revolution" and the catechism of the little red book of *Quotations from Chairman Mao* stimulated their idealistic thought. Mao's "Four Big Rights"<sup>26</sup> incited them to open, vicious criticism of his political rivals.

Chaos soon followed. Classes were suspended and technical schools, colleges and universities shut down as the "Red Guards" literally ran amok. Gangs of "Guard" members terrorized officials, intellectuals, factory workers and peasant farmers alike, breaking into homes and destroying anything they considered "immoral." Many of their victims were beaten. A number were killed. "Red Guard" gangs fought with local authorities and with each other.

By early 1967 Liu, Deng and the other moderates had been "removed" from public life and the Maoist clique had gained political control of the country. However, they had lost control of the "Red Guards." Mao turned to the People's Liberation Army to stop them and maintain order. The final suppression order was given and the "Red Guards" disbanded in July 1968.

Chairman Mao's worries were not confined to domestic problems: American involvement in Vietnam, steady buildup of Soviet troops on China's border and the Soviet invasion of Czechoslovakia were quite unsettling. In response to these stimuli a massive program was launched to build self-sufficient military-industrial bases in China's remote Northwest and Southwest provinces. Nearly half the country's capital investment was poured

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<sup>26</sup>These included "speaking out freely, airing views fully, holding great debates, and writing big-character posters" (*Army Area Handbook*, 1988).

into railroads, factories and power plants in ten provinces that produced only 19 percent of its industrial product in 1965. The whole project was so poorly conceived that much of it could never be finished and was simply abandoned. (Fairbank, 1992)

Formal termination of the activist phase of the "Cultural Revolution" was announced in April 1969 at the Chinese Communist Party's Ninth National Party Congress. Afterward, the government shifted its attention to reestablishing economic stability, rebuilding the Party and improving foreign relations. The "Revolution" was mainly a political movement, but it had adverse effects on China's economy -- some that would last for many years.

Perhaps the worst was the loss of countless potential technicians, professionals and teachers -- all critical to a country's development. Advanced education was simply unavailable to an entire generation. Production in agriculture and industry declined, although industry suffered more. "Red Guard" transportation requisitions prevented delivery of raw materials and supplies. The political activities of students and workers disrupted work schedules and slowed production. Engineers, managers, technicians, teachers and other professionals were demoted, sent to the countryside for manual labor or jailed. Industrial production declined by 14 percent in 1967 (*Army Area Handbook*, 1988). Agriculture followed with a 2.5 percent decline in 1968 as the movement spread to rural areas. Production recovered slightly after suppression of the "Red Guards": between 1966-70 annual growth in the agricultural and industrial sectors averaged 3.9 and 11.7 percent, respectively. National income, gross social product and total industrial-agricultural production grew during this period, but all at rates more than 6 percent below those of 1963-65. (Tsao, 1987)

Hard-line politics again separated the People's Republic from resources for economic development. Reduced production meant fewer exports; fewer exports meant fewer earnings of foreign exchange to buy the things necessary for development. Besides reduced purchasing ability, xenophobia and delusions of "self-sufficiency" curtailed purchases of foreign equipment. China's trade with Japan -- its number one partner at the beginning of the

“Revolution” and a valuable source of modern technology -- suffered a two-year decline. This primarily resulted from Chinese insistence upon including political statements in trade agreements<sup>27</sup> and an inability to meet Japan’s import needs. Many analysts agree that Chairman Mao’s “Cultural Revolution” cost the People’s Republic ten years of development (Tsao, 1987 and Kleinberg, 1990).

## **B. TRANSITION TO A SOCIALIST-MARKET ECONOMY - THE 1970s**

### **1. Getting the Red Out: The Four Modernizations**

The 1970s brought waves of political turmoil and rapid changes in China’s leadership before any long-term stability was achieved under the control of moderate reformers like Hua Guofeng and Deng Xiaoping. As will be detailed in the following paragraphs, the struggle between radical and moderate Party factions was brought to the boiling point twice in 1976 by the deaths of Zhou Enlai (January) and Mao Zedong (September). One of the more notable “pawns” in this ongoing tug-of-war was Deng Xiaoping: within the span of four years he was reinstated (1973), purged a second time (1976), and reinstated again (1977) -- for the final time.

Mao Zedong’s hyper-activist days had ended by 1970 and China’s government, although still factional, was beginning to stabilize. Tasked with accelerating economic development, Premier Zhou Enlai began carrying out a plan that would evolve into his “Four Modernizations” plan. The People’s Republic would improve economic relations with Western countries and import the necessary technology. The United States was a primary target. Zhou decided that a more active international role was necessary also, and in

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<sup>27</sup>The “L-T” agreement expired in 1967. Trade relations were then negotiated annually as “Memorandum” (“M-T”) trade. Inclusion of statements denouncing the policies separating politics and economics and naming the United States, Soviet Union, and specific Japanese political factions as enemies of China and Japan was required. (Jain, 1977)

September 1971 China joined the United Nations. By coincidence, Party Vice Chairman and Defense Minister Lin Biao -- apparently opposed to any shift toward the United States -- died "mysteriously" in a plane crash in Mongolia that same month. He had reportedly staged a coup against Mao and been found out.

Within a year after the Lin Biao incident President Richard M. Nixon paid his historic visit to China and diplomatic relations had been established with Japan. Also, a movement to reinstate Party members who had been "dismissed" or disgraced during the "Cultural Revolution" intensified. Deng Xiaoping reemerged in 1973 and was appointed Vice Premier. He and Zhou formed a powerful team: their moderate line for economic development was formally confirmed at the Tenth National Party Congress<sup>28</sup> in August 1973. Deng made a major contribution to China's efforts by redefining "self-reliance" in a speech delivered at the United Nations in April 1974:

By self-reliance we mean that a country should mainly rely on the strength and wisdom of its own people, control its own economic lifelines, and make full use of its own resources. Self-reliance in no way means self-seclusion and rejection of foreign aid. We have always considered it beneficial and necessary for the development of the national economy that countries should carry on economic and technical exchanges on the basis of respect for state sovereignty, equality and mutual benefit, and the exchange of needed goods to make up for each other's deficiencies. (Tsao, 1987)

In one of his last public acts Zhou Enlai presented his "Four Modernizations" program to the Fourth National People's Congress in January 1975. The program called for concentrated development in four sectors of the economy -- agriculture, industry, science and technology, and national defense. New regulations gave farmers the right to conduct "sideline" production on small private plots of land; factory workers could "moonlight" if they did not employ other workers. The Congress also confirmed Zhou's intended successor, Deng Xiaoping in the concurrent posts of Vice Premier, member of the Politburo Standing Committee and Chief of Staff of the People's Liberation Army.

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<sup>28</sup>Deng was also made a member of the Party's Central Committee at the Tenth Congress.

Meanwhile, a powerful group of Communist Party radicals -- the “Gang of Four”<sup>29</sup> led by Mao Zedong’s wife, Jiang Qing -- had built quite a large support network that included most of China’s media. They launched a massive propaganda campaign during the early 1970s against Zhou, Deng and their economic policies, using official news organs to hurl fierce attacks and promote their own ideology.

Zhou Enlai’s death in January 1976 led to a power struggle between the “Gang” and other Party members. In a compromise move, the Minister of Public Security, Hua Guofeng was named Acting Premier and Chairman of the Central Committee instead of Deng Xiaoping. Then in April a spontaneous demonstration<sup>30</sup> in Beijing’s Tiananmen Square carried strong political overtones of support for Deng. It was suppressed by use of force and Deng was blamed for the disorder. Again he was divested of his official titles and “dismissed.”

In September 1976 Mao died; Hua Guofeng was confirmed as Party Chairman and Premier. Hua, backed by the People’s Liberation Army, arrested the “Gang of Four” and some thirty other radical leaders one month later (Morton, 1995). In August 1977 the Eleventh National Party Congress declared the “Cultural Revolution” officially ended, blamed it on the “Gang of Four” and emphasized the Party’s leadership role in China’s development. Deng Xiaoping was reinstated to all of his previous posts.

Chairman Hua prepared a ten-year economic plan that combined Zhou’s “Four Modernizations” and Mao’s policy of high-speed development, with the added feature of a more moderate approach to foreign trade and investment in China. It called for new investment in industry, agriculture and communications in shares of 54.8, 11.0 and 13.5 percent, respectively. Farm production was to become 85 percent mechanized. Many large-

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<sup>29</sup>The “Gang of Four” headed the remaining element of Shanghai radicals that had served as Mao’s power base for the “Cultural Revolution.” “Gang” members included Jiang Qing, an initiator of the “Cultural Revolution”; Wang Hungwen, a Shanghai radical and deputy Party chairman; Zhang Chunqiao, a vice-premier; and Yao Wenyuan, another Shanghai radical.

<sup>30</sup>Staged by mourners in honor of Zhou.

scale projects were planned including iron, steel and nonferrous metal complexes, coal mines, oil and gas fields, power stations, trunk railways and key harbors. Deng's estimates indicated that China was about \$300 billion short of the capital needed to finance the Ten-Year-Plan. (Tsao, 1987)

Within a year the Plan's ambitious projects ran into problems, mainly caused by mismanagement and shortages of money, materials and modern technology. Many were not completed on time or had to be abandoned. Standards of living remained low throughout the country. Still, the economy as a whole began to show signs of recovery. After three consecutive years of bad weather the agricultural sector came back with a record harvest in 1978; industrial production grew by 14 percent in 1977 and 13 percent in 1978 (*Army Area Handbook*, 1988).

## 2. Beginning Reform

In December 1978 at the Third Plenum of the Eleventh Chinese Communist Party Central Committee, leaders decided to revise the Ten-Year Plan and begin gradual but fundamental economic reforms. Government planning and direct control would be reduced and the role of market forces increased to improve -- not replace -- the socialist system. The Ten-Year Plan was replaced by one for a three-year "period of adjustment" that was to last from 1979-81. A new open-door policy and a program<sup>31</sup> based on four principles -- "adjustment," "reform," "reorganization" and "elevation" -- were also introduced. The government's main goals for the adjustment period included rapid expansion of exports, correcting deficiencies in growth-related infrastructure and building materials, and balancing growth between heavy and light industry.

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<sup>31</sup>This was commonly called the "eight-character" program for the eight Chinese characters that represented the four principles.

Planned industrial output targets and capital expenditures were considerably reduced from those previously set in the Ten-Year Plan. Other changes included suspension of 348 large- and medium-sized projects, cancellation of 4,500 small projects and raising state loans for textile and light industry to \$1.2 billion. Some \$300 million was allocated for importing machinery and raw materials. (Tsao, 1987) Urban workers were given their first increase in wages for the first time in over a decade and a half. Productivity was further motivated by the restoration of incentives such as promotions, piece rates and bonuses for good performance.

Sweeping reforms in the agricultural sector began in 1979 with a sharp rise in prices paid for quota produce.<sup>32</sup> The pivotal innovation, however, was the introduction of the "contract responsibility" system. Each farm family was given the use of a plot of land to work for profit in return for delivering quota produce to the collective. They were allowed considerable freedom to decide what to produce and how to produce it. This guaranteed farmers a means of earning at least a subsistence income. They did not own the land therefore they could not sell, rent or give it away for any reason. Some families were allowed to devote their efforts to the production of scarce commodities or services for a profit. The establishment of free farmers' markets in rural and urban areas was officially encouraged.

### **3. Expanding Trade**

Under Zhou Enlai's policies, the People's Republic of China did not wait for political recognition to expand trade with non-Communist countries. Japan had already become China's number one trading partner again in 1970. After 1971 President Nixon relaxed the 21-year-old embargo and trade with the United States increased rapidly, rising from \$5 million in 1971 to \$930 million by 1974 (Watts, et al., 1979). Most obstacles to trade with

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<sup>32</sup>Each commune had to meet a quota of produce to be delivered to the state at set prices.

Japan and the United States were removed by the signing of joint communiqües in 1972 and 1973, respectively. After 1976 efforts to expand trade and import modern Western technology increased under the direction of Hua Guofeng and Deng Xiaoping. Procedures were changed to allow individual Chinese enterprises and administrative departments outside the Ministry of Foreign Trade to negotiate directly with foreign firms. By the time the "opening up" policy became effective in 1979, a full 87 percent of the gross value of China's trade was with non-Communist countries (Kleinberg, 1990). Japan remained its largest trading partner, with Hong Kong consistently occupying the number two position. During the 1970s China continually ran trade deficits with Japan and the United States (except in 1972 and 1977), surpluses with Hong Kong, and a relative balance with the Soviet Union. As shown in Table 3-6 below, the dollar value of trade with the Soviet Union increased through the 1970s, but remained only a small portion of the total.

Table 3-6. Trade with Selected Countries (millions of US dollars/percentage of total).  
(After Kleinberg, 1990)

	1970	1975	1980
Total two-way trade	4,590	14,750	37,820
With Japan	806.5	3,795.5	9,201.1
With Hong Kong	592.5	1,683.5	4,923.1
With the United States	0	470.7	4,811.3
With the Soviet Union	47.2	297.2	492.4
Japan %	17.6	25.7	24.3
Hong Kong %	12.9	11.4	13.0
United States %	---	3.2	12.7
Soviet Union %	1.0	2.0	1.3

The composition of China's exports and imports was strongly affected by changes in the government's policies. Generally, when "self-reliance" was in vogue more emphasis was

placed on exporting primary and agricultural products and importing consumption goods. During periods of expansion, emphasis shifted to exports of industrial and mineral goods and imports of capital goods (Tsao, 1987 and Kleinberg, 1990). These trends are illustrated in Tables 3-7 and 3-8 below.

Table 3-7. Percentage Composition of China's Exports (After Kleinberg, 1990).

	1970	1975	1980
Agricultural and sideline	36.4	29.6	18.7
Light industrial	26.2	23.9	24.0
Textiles	21.4	17.9	17.9
Heavy industrial	15.7	28.6	39.4

Table 3-8. Percentage Composition of China's Imports (After Kleinberg, 1990).

	1970	1975	1980
Machinery and equipment	15.8	32.1	27.5
Industrial raw materials	57.4	45.7	44.1
Raw materials for agriculture	9.5	7.6	7.3
Food and consumer goods	17.3	14.6	21.1

The textile and petroleum industries played an important role in China's development during the late 1970s. Profits turned over to the state from the textile industry accounted for 10 percent of state revenues, 20 percent of total retail sales and 20 percent of total foreign exchange earnings from exports (Tsao, 1987). In fact, exports to the United States were so

“successful” that President Jimmy Carter ordered unilateral quantitative trade restrictions<sup>33</sup> on nine Chinese apparel items in 1979. Exports of crude oil and petroleum helped to keep trade deficits down and allowed China to buy more imports of Japanese machinery, equipment and steel (Kleinberg, 1990).

#### **4. Importing Technology**

Zhou Enlai’s efforts to import technology during the early 1970s led to contracts with foreign firms for the construction of large chemical fertilizer, steel finishing and oil extraction and refining facilities. Most notably, normalization of relations with Japan brought imports of entire industrial plants and associated technology -- financed by credits from Japan’s Import-Export Bank. Contracts were concluded by the summer of 1973 for several plants totaling approximately \$250 million. In June 1974 China bought a steel plant from Japan’s Nippon Steel worth \$215.6 million, capable of annually producing 3 million tons of hot rollings and 70,000 tons of silicon steel plate. Along with it went 350 Japanese technicians as technical guides for plant construction and operation; about 300 Chinese technicians would be trained in Japan. Other purchases from Japan in the early 1970s included two thermal power units and a fertilizer complex worth more than \$80 million and \$40 million, respectively. (Jain, 1977)

China’s imports from the United States during the early part of the decade included high-technology items such as Boeing 707 aircraft, Pratt and Whitney jet engines and television broadcasting satellite systems. However, advanced American technology was largely unavailable from the mid- to late 1970s for many reasons, most of them political. Until relations were normalized in January 1979, United States exports to China were subject to controls imposed on Communist states in the 1950s. China’s political instability and

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<sup>33</sup>These trade restrictions were removed in September 1980 when the first textile agreement between the two countries was signed.

generally negative attitudes toward long-term foreign loans, presence of foreign managers in Chinese businesses and formation of joint ventures with foreigners simply turned many American companies off. (Harding, 1992)

Perhaps the most serious problems the People's Republic faced in acquiring modern technology from abroad were the lack of indigenous technically-educated workers and the sad state of its educational system. Technology could be purchased, but the country's ability to absorb it was another matter. Many schools and universities closed during the "Cultural Revolution" did not reopen until the late 1970s. In the universities that did reopen early in the decade, the quality of education provided was poor: students were admitted for their political clout rather than academic achievements. Serious efforts to improve the quality of education only came after 1976, when the government renewed emphasis on growth and development through adoption of foreign technology. Academic merit and advanced training were back "in," political links, "out." Deng Xiaoping conveyed the new policy in a 1978 speech to the National Science Conference:

The crux of the Four Modernizations is the mastery of modern science and technology. Without the high-speed development of science and technology, it is impossible to develop the national economy at high speed. (*Army Area Handbook*, 1988)

One of the Chinese government's more important moves toward attracting foreign investment and technology transfers was made in 1979. It was the establishment of four coastal "Special Economic Zones." Three of them -- the cities of Shenzhen, Zhuhai and Shantou -- were in Guangdong Province, close to Hong Kong. The fourth, Xiamen, was in Fujian Province, directly across the strait from Taiwan. These "Zones" were supposed to allow the government better control over introduction of capitalist practices and foreign technology while "opening" to foreign investment. The basic idea was to build detached enclaves where advanced foreign technology and management methods could be studied and applied selectively elsewhere. Incentives such as special tax breaks and liberalized regulations

for employment and wages, investment, and joint ventures were used to attract foreign investors to the "Zones."

## **5. Foreign Aid, Loans and Investment**

The People's Republic was a "late starter" in securing foreign aid, loans and investment during the 1970s. After the Sino-Soviet split, China became a very cautious borrower. Policies promoting Maoist "self-sufficiency" lingered through the years of political turmoil: until the moderates consolidated power and began reforms in 1978, foreign investments were barred and commercial credits largely rejected. When credits were accepted -- as with the industrial plants purchased from Japan -- they were usually negotiated for medium-term repayment schemes of five years or so (Garver, 1993). Foreign aid was given rather than received,<sup>34</sup> although unreported remittances from overseas Chinese provided the mainland a sort of aid by injecting foreign currency into the economy.

Outward-looking policies adopted in 1978 opened the door to foreign investment in China. Most early foreign direct investment projects were agricultural or service-oriented and employed unsophisticated technology. However, the opening of the "Special Economic Zones" and passage of a new Joint Venture Law in 1979 set the stage for investment projects involving advanced technology in the 1980s.

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<sup>34</sup>The People's Republic began sending foreign aid -- mostly aid in kind -- to small Communist and non-Communist countries in Asia during the 1950s. Radical African countries and Albania became recipients in the 1960s. Disbursements were suspended during the "Cultural Revolution," but resumed in 1970 and quickly increased. Through 1977, China's largest aid recipients included North Vietnam, North Korea and Albania; aid to these three totaled between \$4.5-\$33 billion. Aid to non-Communist countries between 1956-77 amounted to some \$2.26 billion. Disbursements were reduced dramatically after 1978, when aid to North Vietnam and Albania were suspended and the Chinese leadership began channeling resources to China's own development efforts. (Garver, 1993)

## 6. The Relationship Between Stabilization and Growth

Overall economic performance during the decade strongly reflected China's periods of political turmoil. As the data in Table 3-9 below suggests, the activist period of the "Cultural Revolution" (1966-69), followed by political instability until the late 1970s had a negative affect on growth. Reforms and relative political stability after 1977 led to a partial recovery by 1980. Between 1976-80 agricultural and industrial output grew at an average of 4.9 and 9.2 percent, respectively (Tsao, 1987).

Table 3-9. Annual Average Growth Rates of China's Major Economic Indicators  
(After Tsao, 1987)

Period	National Income	Gross Social Product	Gross Value of Industrial and Agricultural Product
1966-1970	8.3	9.3	9.6
1971-1975	5.5	7.3	7.8
1976-1980	6.2	8.0	8.0

Mao Zedong's development policies were obvious failures. The policies of the more moderate leaders -- whenever they were applied -- appeared very successful. Following the rise of the new leadership in the late 1970s Mao was severely criticized. Perhaps the most accurate criticism and assessment of his career was voiced by Chen Yun in 1978:

If Chairman Mao had died in 1956, there would have been no doubt that he was a great leader of the Chinese people, a revolutionary teacher respected and beloved by all Chinese, and a great man in the proletarian revolutionary movement of the world. If he had died in 1966, his meritorious achievements would have been sullied but still good. Since he actually died in 1976, we can do nothing about it. (Tsao, 1987)

As the decade ended, reform-minded leaders were firmly in control and the economy was taking an upward turn. A treaty of peace and friendship was signed with Japan in 1978.

The year 1979 saw the establishment of diplomatic relations with the United States and a determination by China not to extend the thirty-year-old treaty with the Soviet Union. The People's Republic was on its way to integration with the capitalist world economy.

### C. "OPENING UP" CHINA - THE 1980s

#### 1. Building New Foundations

"China's leadership after 1976 . . . placed the pursuit of 'wealth and power' for the nation second only to the security and independence of the Chinese state." (Perkins, 1986) According to their new strategy, a solid foundation for development was to be laid in the 1980s; the foundations for high growth rates were to follow in the 1990s. The Sixth Five-Year Plan (1981-85) -- the first under the leadership of Deng Xiaoping, Chairman Hu Yaobang and Premier Zhao Ziyang -- concentrated on economic and social development. In 1982 a new state constitution was adopted, providing a legal framework for reform in the People's Republic.

Between 1981-85 about 59 percent of state expenditures<sup>35</sup> were budgeted for investment in fixed assets: 37.7 percent went to capital construction and 21.3 percent for updating and rebuilding equipment and facilities. Sectors that received high priority for construction included energy, communications and transportation. A total of 890 large- and medium-sized construction projects were planned, with 120 of them given top priority as "key" projects. Twenty-one of 70 key projects under construction in 1983 were built with either foreign capital or complete sets of imported equipment. Upgrades and reconstruction were planned in a variety of other sectors -- from textiles and chemicals to education and public health services. (Tsao, 1987)

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<sup>35</sup>Of total state expenditures, 4.3 percent came from foreign sources (Tsao, 1987).

Following the planners' two-stage strategy, the Seventh Five-Year Plan (1986-90) generally set growth targets higher than those of the Sixth Plan, but lower than had been achieved by it. Investment expenditures for capital construction were provided by state and local authorities in shares of 75 and 22.5 percent, respectively. The other 2.5 percent came from a combination of sources and was directed to the four "Special Economic Zones" and construction of a nuclear power plant in Guangdong.<sup>36</sup> (Tsao, 1987) As indicated in Table 3-10, energy continued to receive a large portion of the state's expenditures between 1986-90.

Table 3-10. Percentages of Expenditures for Selected Sectors, 1986-90.  
(After Tsao, 1987)

Sector	Share of total investment funds
Energy	23.5
Communications and transportation	11.4
Agriculture (including forestry, water conservation and meteorological services)	2.9
Textiles and other light industry	2.1
Raw and semifinished materials	15.6
Machine building and electronics	1.8
Defense	4.1

Reforms begun in the late 1970s reached full force in the 1980s. The "contract responsibility" system and other changes breathed new life into China's agricultural sector. Although production had grown since 1949, the gains had been largely matched by population growth; the trend was reversed in the 1980s and China became self-sufficient in grain

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<sup>36</sup>This was the first time a nuclear power plant was included in a Chinese economic development plan.

production. Decentralization in decision-making, increased reliance on markets and pricing improvements were the catalysts.

By 1985 about 98 percent of all farmers were operating under the "contract responsibility" system and communes were effectively eliminated (*Army Area Handbook*, 1988). With the farmers thus allowed to operate on their own, agricultural production more than doubled. Consequently, market sales increased the farmers' incomes and more food and other agricultural products became available in urban areas. The psychological effect of the change was perhaps more important than material gains. As Goldman (1993) wrote: "The sudden increase in food and other consumer goods . . . created the feeling in the Chinese public at large that the reform might work after all."

Non-agricultural output in the rural sector was also increased by the introduction of township enterprises -- collective enterprises owned and operated by individual villages. Township enterprises helped to absorb surplus labor and accounted for 23 percent of China's rural output during the 1980s (U.S. Department of State, 1993). These were completely "sideline" businesses; the state did not guarantee a supply of materials or a market for their output. Materials would be bought and sold at market prices. Employment was not guaranteed and expansion or contraction of the businesses depended upon performance. Profits were shared by managers and workers as small bonuses, by the state and provincial government through an income tax. The remainder was allocated to various benefits -- such as housing, roads, education and health -- for the workers and the village. These businesses had low capital-to-labor ratios and did not require a great deal of investment in infrastructure or overhead. By 1988 participation had grown to 93 million farmers (Gordon, 1992).

China's urban state industry reforms began in 1980, based on Zhao Ziyang's highly successful industrial policies used in Sichuan Province during the late 1970s.<sup>37</sup> Enterprises were allowed to keep a share of their profits and the state's share was converted to an income

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<sup>37</sup>Zhao's success in reviving the Sichuan economy weighed heavily toward his promotion to Premier in 1980.

tax. Materials could be bought and products sold beyond state quotas at market prices. The gap between quota and market prices was reduced for "key" industries; price controls and material allocations were curtailed or stopped for industries where supply exceeded demand. Managers were given the authority to hire, fire, set wages and give bonuses. They could also keep some of the profit -- after taxes and other required payments had been made. An employment merit system was introduced in 1982 to promote hard work and efficiency among workers.<sup>38</sup>

The Chinese government also encouraged privately owned enterprises in the urban sector to absorb surplus labor and increase the supply of light industrial products. Some smaller state-owned firms were sold or leased to private entrepreneurs. The presence of independent small businessmen -- tailors, shoemakers, vendors and the like -- became commonplace. Between 1978-87 the state's shares of industrial output and retail sales fell from 81 and 91 to below 60 and 40 percent, respectively (Harding, 1992).

Revitalizing the country's educational system at all levels was a primary concern. Chinese government statistics showed that about 21 percent of the population was illiterate or semiliterate in 1985 (*Army Area Handbook*, 1988). By 1986 a compulsory nine-year education law was in effect that made six years of primary, three years of middle school education mandatory. The law also focused on the consolidation of existing schools and improving the quality of education provided. Demand was growing for advanced education, but a scarcity of available placements in colleges and universities<sup>39</sup> meant that less than 0.2 percent of the Chinese population could attend (Fairbank, 1992). To compensate, alternate forms of higher education were set up. Programs such as industry-sponsored training

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<sup>38</sup>This was heralded as the end of Mao's idealistic "iron rice bowl" -- guaranteed jobs at guaranteed wages.

<sup>39</sup>In 1980 there were about 20 applicants for each placement -- the government could not afford to fund any more at that time (Fairbank, 1992).

institutes and spare-time, part-time, radio and television university classes became available to millions in rural and urban areas.

Advanced education and training in fields critical to development were also imported. Some lucky students were sent abroad for higher education. Even in the 1960s and 1970s, the Chinese government had continued to send a few students to foreign colleges and universities, mostly in Europe. Between 1978-84 more than 36,000 students -- including some 7,000 who were self-supporting -- went to study in 14 countries. About 78 percent of these were technical personnel.<sup>40</sup> (*Army Area Handbook*, 1988) By 1988 the number of Chinese studying in the United States reached 40,000 -- they were the largest group of foreign students in American universities (Harding, 1992).

During the 1980s more emphasis was also placed on reforming and modernizing China's defense organization. The government's goal was to develop a well-disciplined, professional military that was proficient in handling sophisticated modern weaponry. Distinctive military uniforms and rank insignia -- abolished during the "Cultural Revolution" -- were restored. Foreign weapons and systems were imported to upgrade the military's capabilities. Financial constraints led to downsizing and reorganization in 1985. Afterward, the military lost its prominence in the Communist Party's Central Committee and became less active politically. Manpower was reduced nearly 25 percent, but even then, the People's Liberation Army remained one of the largest in the world. And this force of more than 3 million personnel was being converted from a people's militia to a professional military machine. (Morton, 1995)

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<sup>40</sup>Many students sent abroad -- particularly to the United States -- were mid-career scientists and technicians in their thirties and forties (*Army Area Handbook*, 1988).

## 2. Attracting Investment, Expanding Trade and Importing Technology

The 1980s were truly a decade of “opening” for foreign trade and investment in the People’s Republic of China. Provinces and cities were allowed to form their own trade organizations, approve routine import and export contracts and keep a portion of hard currency export earnings. New laws -- such as the Economic Contract Law, Patent Law and Cooperative Joint Venture Law -- were issued to protect the rights of Chinese and foreign partners. The four original “Special Economic Zones” were so successful that by 1984 the government decided to “open” more. The goal was to increase foreign investment and broaden its reach so that the domestic economy could assimilate the imported technology with greater ease. Between 1984-88 the areas surrounding fourteen other coastal cities,<sup>41</sup> four large sections extending inland on the Yangzi, Pearl and Yellow river deltas and in southern Fujian Province, and Hainan Island were “opened.” Contracts with foreign investors were approved in a variety of forms, including direct technology license purchases, contracted co-production with foreign firms and the hiring of technical consultants.

Between 1979-87 foreign direct investment in China totaled about \$8.47 billion in more than 4,000 joint ventures of various kinds. Guangdong Province received the most -- about 60 percent of the total -- and grew rapidly to account for nearly 20 percent of China’s export production. Wholly foreign-owned ventures were “welcomed,” but apparently limited. By 1983 about thirty of them worth \$200 million were approved; most were in the “Special Economic Zones.” (Kleinberg, 1990).

Hong Kong became a major source of foreign direct investment for the People’s Republic, especially in Guangdong Province. During the 1980s some 95,000 projects and thousands of small- and medium-sized manufacturers shifted operations from Hong Kong to Guangdong (Abegglen, 1994). American investment increased rapidly, and by 1988 the

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<sup>41</sup>The fourteen coastal cities included Dalian, Tianjin, Shanghai and Guangzhou -- all major commercial and industrial centers.

United States was second only to Hong Kong in total cumulative foreign investment used by China (Harding, 1992). Japan's direct investment increased also, but total commitments remained less than those of the United States. By 1990 cumulative American and Japanese direct investment commitments totaled about \$4.4 billion and \$3.4 billion, respectively (Harding, 1992 and *Global Economic and Technological Change*, 1993).

The expansion in trade begun in the late 1970s accelerated during the 1980s. Foreign trade became a significant factor as a percentage of China's national income for the first time, climbing steadily from 15.6 percent in 1980 to 32.5 percent in 1988 (Garver, 1993). After gaining "observer" status in 1982 and "special observer" status in 1984, the People's Republic began sending delegations to attend regular and Council meetings of the General Agreement on Tariffs and Trade (GATT). "Opening up" improved the country's international standing and status: China advanced from thirty-fourth to fourteenth place in world trade value between 1976-88 (Hardt, et al., 1990).

Growth in imports was primarily supported by the rapid expansion of export earnings rather than increased debt. To ensure expansion of exports and increased earnings, the government issued protectionist regulations in licensing, tariffs and duties, pricing, customs inspections and foreign exchange.<sup>42</sup> These levers were employed as needed to maintain control over China's balance of trade. Decentralization provided greater freedom and incentive for individual localities and enterprises to increase exports. It also led to periodic spurts in import purchasing that outstripped the country's foreign exchange earnings. The state issued regulatory adjustments in 1981-82, 1985 and 1988 to compensate for overspending on imports and prevent a drain of scarce domestic goods through exports. Chinese trade policies during the 1980s were best described by a Ministry of Foreign

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<sup>42</sup>Import substitution policies in the People's Republic were designed to protect all indigenous industries, not just "key" or "infant" ones. Generally, items that could be produced at home in sufficient quantity were subject to stricter controls than those needed for development or to augment indigenous production in periods of shortage. As Kleinberg (1990) wrote: "From before the beginning of the opening up policy, Chinese officials and economists made clear that foreign trade would be a supplement and contributor to, not a replacement of, self-reliant industrial development."

Economic Relations and Trade spokesman in 1986: "Decentralization and control are two sides of one coin." (Kleinberg, 1990)

Japan, Hong Kong and the United States continued as China's top trading partners throughout the decade. Trade with the Soviet Union continued to grow slowly, the bulk of it as barter agreements totaling less than \$3 billion per year (Kleinberg, 1990). Bilateral trade relations were established with many others despite any political differences; the most notable of these were South Korea and Taiwan. Their comparative advantages -- particularly over Japan -- in a variety of products and complementarity with China's economy led to trade exceeding \$2 billion per year with each by the late 1980s (Kleinberg, 1990 and Harding, 1992). Although the People's Republic expanded trade with many partners during the 1980s the United States and Japan remained its main sources of advanced technology.<sup>43</sup> Trade with both increased in absolute terms, but as Table 3-11 below shows, the gap between their relative shares of China's total trade narrowed between 1980-90.

The value of bilateral trade with Japan more than doubled over the decade despite several episodes of friction over China's trade deficit and politically sensitive issues.<sup>44</sup> By the mid-1980s Japan provided about one-third of China's imports and purchased about one-fourth its exports (Mandelbaum, 1995). Imports from Japan consisted mainly of sophisticated industrial machinery, electrical equipment and steel products, while exports sent there were still mostly agricultural products, coal, oil and textiles.

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<sup>43</sup>Hong Kong retained the number two position in overall trade and remained an important source of foreign exchange for China. However, its main function as a transshipment port meant that its impact on Chinese development was more indirect.

<sup>44</sup>Japanese Prime Minister Nakasone's 1985 visit to the Yasukuni Shrine, which commemorates Japan's war dead, and the 1986 revision of Japanese history textbooks to soften accounts of Japan's actions in World War II drew strong complaints from Chinese officials.

Table 3-11. Trade with Japan and the United States (millions of US dollars/percentage of total). (After Kleinberg, 1990, *The Far East and Australasia*, 1992 edition and *The Summary Report: Trade of Japan*, 1992 edition)

	1980	1985	1990
Total two-way trade	37,820	69,600	115,413
With Japan	9,201.1	16,434.4	19,533.0
With the United States	4,811.3	7,025.0	13,048.0
Japan %	24.3	23.6	16.9
United States %	6.9	10.1	11.3

Trade with the United States surged, increasing about 270 percent in value between 1980-90. By 1983 textile and apparel products accounted for 44.2 percent of American imports from the People's Republic (Morton, 1995). Their "success" again became a source of friction: responding to domestic pressures, the American government placed unilateral import restrictions on Chinese textiles in January 1983. China reciprocated by announcing a planned reduction in purchases of American agricultural products and barring further contracts for American cotton and manmade fibers. The dispute was ended with the signing of a new bilateral textile agreement in August.<sup>45</sup>

Meanwhile, relaxation of American restrictions on exports of advanced technology to China was extended to include those with actual or potential military applications. In 1984 China became eligible to purchase American military equipment from the United States government under the Foreign Military Sales (FMS) program. Military equipment purchases between 1984-86 included antitank, antiaircraft and antisubmarine weapons, and more than \$500 million in fighter aircraft radar, navigation and computer equipment (Morton, 1995).

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<sup>45</sup>Renewal of the agreement in 1987 required difficult negotiations, but it was concluded without the imposition of unilateral quotas.

American arms deliveries increased from \$8 million in 1984 to \$106.2 million in 1989 (Harding, 1992).

During the 1980s the composition of China's imports and exports followed the same general trends as in the 1970s. The focus on expansion led to an increase in imports of industrial machinery and other capital goods, and a decrease in imports of food and consumer goods (Kleinberg, 1990). As shown in Table 3-12 below, exports of manufactures and primary commodities showed the most dramatic changes between 1978-89.

Table 3-12. Percentage Shares of Merchandise Exports.  
(After *World Development Report*, various)

	Fuels, Minerals and Metals	Other Primary Commodities	Textiles and Clothing	Machinery and Transportation Equipment	Other Manufactures
1978	13	38	24	3	22
1989	11	19	25	7	63
1992	7	14	30	15	64

### 3. Financing Development with Aid and Loans

The People's Republic also "opened up" to new sources of financial assistance after 1978. It began seeking money from organizations such as the International Development Association, World Bank and United Nations Development Program. The government released relatively complete economic statistics in 1979 and 1980 that exposed the country's poverty, but increased its eligibility for concessional loans. By the end of 1980, China was a member of the International Monetary Fund and World Bank and had \$20 billion available in international credit (Kleinberg, 1990); by 1982 it was the largest recipient of multilateral development aid (Garver, 1993).

Japan was by far the largest single contributor, providing nearly \$1 billion per year in official development assistance (ODA) and loans during the 1980s (Kleinberg, 1990). Conversely, China was Japan's largest single recipient of ODA for several consecutive years. Most Japanese aid was directed to the development of infrastructure and energy resources. Two large sets of loans were granted by 1983: one from Japan's Overseas Economic Cooperation Fund for \$3.5 billion to be used for basic infrastructure projects; the other from the Japan Export-Import Bank for \$2 billion<sup>46</sup> to fund oil exploration and coal mining projects (*Army Area Handbook*, 1993). Bilateral aid and loans also contributed to the expansion of commercial trade. Besides funding the modernization of the necessary infrastructure -- such as port and rail facilities -- they financed purchases of industrial facilities and equipment that enhanced China's export production capability.

Official financial assistance from the United States was limited through most of the 1980s. The legal prohibition on extending aid to Communist countries through America's primary instrument -- the Agency for International Development -- was not waived for China until the end of 1985. Some aid and loans were dispensed through other agencies, however. By the end of 1988 China received \$349 million in trade financing, \$95.5 million in investment guarantees and \$22.6 million in trade promotions through the Eximbank, Overseas Private Investment Corporation (OPIC) and Trade Development Program (TDP) of the Department of Commerce, respectively. Official joint projects in scientific and technological cooperation provided an additional \$10-20 million per year by 1987. However, one of the largest sources of direct American investment in China's development was financial support for officially sponsored Chinese students and scholars. By the mid-1980s American universities, corporations and foundations were providing almost two-thirds of their fellowships, which amounted to about \$80 million per year. (Harding, 1992)

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<sup>46</sup>This loan carried an annual interest rate of 6.25 percent -- the lowest rate China had received from any country to date (*Army Area Handbook*, 1993).

During the early years of "opening up," China received bilateral assistance from other countries as well. For example, a 50-year loan for \$31.5 million was obtained from Belgium -- interest free (Kleinberg, 1990). And Soviet economic and technical experts were sent to China in 1984 to help modernize some factories and projects the Soviet Union had originally built in the 1950s.

The People's Republic used some \$3-5 billion in economic aid between 1981-86 alone (Kleinberg, 1990). However, by 1989, net ODA receipts still only amounted to 0.5 percent of gross national product (GNP) (*Development Co-operation*, 1994); foreign debt had accumulated to about \$33.1 billion, but most of it was in "soft" long-term loans at concessionary rates (Kleinberg, 1990).

#### **4. Rapid Growth and its Side Effects**

The Sixth and Seventh Five-Year Plans were highly successful. Reforms in agriculture and industry greatly increased productivity and output: by 1985 relaxation of target levels and more effective use of resources yielded output in all sectors of the economy that exceeded government plans (Tsao, 1987). Between 1980-91 per capita GNP grew at an average of 7.8 percent annually (*World Development Report*, 1993). As shown in Tables 3-13 and 3-14 below, growth in China's modern sectors was nearly double that of the agricultural sector, but their relative contributions to GNP remained fairly constant over the decade. Most notable was the growth in services -- a clear indicator of advancing economic development.

Ironically, the same policies that sparked rapid growth in productivity caused some serious problems for the People's Republic. Private land use and collective enterprises generally increased the incomes of rural families. However, greater inequalities began to develop between villages in the interior and those on the coast or near large cities because of differential opportunities for industrialization and access to urban markets. Regional income inequalities also widened along with the growth of "Special Economic Zones."

Table 3-13. Average Annual Growth Rates 1980-91 (percentage).  
 (After *World Development Report*, 1993)

Gross National Product	9.4
Agriculture	5.7
Industry	11.0
Manufacturing	11.1
Services	11.2

Table 3-14. Distribution of Gross National Product (percentage).  
 (After *World Development Report*, various)

	1979	1986	1991
GNP (\$ million)	252,230	271,880	369,651
Agriculture	31	31	27
Industry	47	46	42
Manufacturing	30+	34	38
Services	22	23	32

Relaxed central control over the industrial sector contributed both to improved performance and the rise of corruption: unethical managers soon found ways -- many of them illegal -- to use their improved positions of power for personal gain at the expense of their enterprises. Increased flexibility in employment practices and geographically uneven industrial growth led to fluctuations in employment patterns; unemployment began to rise, especially during the late 1980s.

Inflation became a major problem for China. Greater prosperity increased the demand for consumer goods, but their supplies were limited. Price structures were still controlled at the center and could not respond to market demands. Intense competition between provincial and local governments hoping to profit from consumer goods sales led to growth in the light

industry sector, but it also caused shortages of basic supplies and the bidding up of labor costs. Wherever planning was poor or production below normal -- for whatever reason -- there were chronic shortages of goods. By the late 1980s prices in major cities were increasing by 30-40 percent annually (Harding, 1992).

By the end of 1988 China's central leadership had split over the future pace and course of reforms, and the balance of power shifted from more radical reformers like Zhao Ziyang to the more cautious ones like Li Peng. Severe austerity measures were carried out in an attempt to control inflation. Socioeconomic problems and political struggle fueled popular unrest. China's internal problems finally came to a head -- and gained international attention -- in June 1989 with the state's "repression" of protestors in Tiananmen Square.

##### **5. Tiananmen Square: A Watershed for Relations (?)**

Immediately following the Tiananmen Square incident, China's foreign trade and investment were subjected to a variety of sanctions imposed by foreign partners. The United States suspended many programs, including: ongoing consideration of increased liberalization of exports to China; new activities under the Trade Development Program (TDP) and Overseas Private Investment Corporation (OPIC); all government-to-government and private sales of weapons and dual-use technology to the Chinese military and police; and export licensing for munitions and satellites. Japan generally followed the American lead in limiting relations advantageous to China. However, the Japanese showed a less confrontational, more low-key approach. Foreign direct investment from both dropped in the year immediately following -- America's by 44 percent and Japan's about 20 percent -- but began to recover shortly afterward (Harding, 1992 and *Global Economic and Technological Change*, 1993).

Despite the sanctions, the total volume of China's bilateral trade with the United States and Japan continued to increase. Sanctions reduced only some foreign exports to China; they did not restrict China's exports. To the contrary, Chinese exports multiplied after

Tiananmen for a variety of reasons, among them, the government's inflation-fighting austerity measures and reduced access to foreign finances.

The World Bank initially reacted to the Tiananmen incident by terminating consideration of new loans to the People's Republic; many bilateral donors froze their assistance programs. However, in the year that followed the World bank and most other donors -- except the United States -- resumed normal relationships. Lending by foreign governments fell by half, but lending by international organizations doubled (Garver, 1993). China's largest bilateral donor -- Japan -- never seriously scaled back official or private-sector activity in China. Within three months of the Tiananmen incident, existing aid and loan disbursements resumed and Japanese technical assistance personnel returned to China. Disbursements under a new five-year loan for 1990-95 worth about \$1 billion per year were only delayed by a year. (Lincoln, 1993)

Other than a few brief setbacks, then, the Tiananmen incident did not adversely affect China's foreign economic transactions in overall volume or dollar value. The balance of exchanges continued to swell after the incident, increasingly to China's benefit. What Tiananmen did, however, was to help politicize economic links with many partners -- particularly the United States. Nearly two decades of building goodwill were lost as relationships took on a more apprehensive, often acrimonious tone.

#### **D. CONTINUING DEVELOPMENT INTO THE 1990s**

##### **1. The Domestic Situation**

Despite its growing pains, the People's Republic of China is the fastest growing major economy in the world. Double-digit growth in the country's GNP has persisted into the 1990s, totaling 12.8 percent in 1992 and 13.4 percent in 1993 (Nelan, 1993 and *CIA World Factbook*, 1994). Industrial production continued to surge, and by 1993 registered a 25

percent growth rate and accounted for nearly 60 percent of GNP (U.S. Department of State, 1993). Collective rural industries are expanding at a rapid pace; many farmers have turned to light manufactures as a primary source of income. Villages are becoming towns, towns are becoming cities, and industry is starting to infringe upon agriculture. Like Japan and South Korea before it, China is beginning to import more food as its development process gains momentum. Current newspapers and magazines are full of reports about Chinese progress -- from the acceleration of urban housing construction and spread of cable television to the successful overhaul and refueling of China's first home-designed nuclear power station at Qinshan.

The rapid pace of development in the People's Republic has been impressive. However, many problems remain. Growth is still unevenly distributed, mostly centered in the "Special Economic Zones," big cities and along the coast, with the agricultural interior lagging behind. The southern provinces are leading the northern ones. Rural and urban incomes have increased significantly, but farmers still average only about half the urban factory workers' wages. Many in the interior are still stuck in subsistence farming. Per capita income is low by international standards. Estimates vary, but most agree that the average annual Chinese income was less than \$500 through 1994. Government infrastructure projects suffer from lack of funds; China's total mileage of railroads -- the main means of transport for people and goods -- equals one-third that of the United States in the 1880s (Kahn, 1995). Inflation is still a big problem, as are crime, corruption and gross inefficiency -- especially in state-run enterprises<sup>47</sup>.

The current Eighth Five-Year Plan (1991-95) emphasizes development in agriculture, basic industries, transportation and telecommunications. It promotes the continuation of economic reforms and "opening" to the outside while maintaining the primacy of state

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<sup>47</sup>Recent official Chinese press reports indicated that state-run enterprises, with assets totaling some \$300 billion, are more than \$200 billion in debt (Chen and Kahn, 1995).

ownership and control<sup>48</sup>. The Chinese leadership has clearly stated that the stability of China's social environment will take precedence over reforms: they do not wish to repeat the former Soviet Union's mistake of attempting too many reforms at too fast a pace. This could help to explain why they have kept responding to many of the country's economic problems by returning to the old central planning techniques.

So far in the 1990s, China's leaders have tried various measures to cure some of its economic ills. Efforts to solve the problems of inefficient state-held enterprises have included increasing purchases and investment in advanced foreign technology, converting some enterprises into stock corporations, and allowing open market competition to drive some of them out of business. Incompetency has been attacked through dismissals and civil service entrance examinations, while a crackdown on corruption has led to the arrest of numerous officials at the county level and above. To get control of China's chaotic fiscal and monetary systems, the government has instituted reforms in its tax system and central banking operation. Beijing instituted a unified tax system and -- for the first time -- began collecting personal income taxes and value-added taxes in 1994 (Kahn, 1995). A central bank law was passed early in 1995 to give the People's Bank of China (PBOC) more independence from the state and the power to issue currency, control credit lines, manage the base currency and regulate base interest rates. Around the same time, Premier Li Peng announced an overall retrenchment in China's reform policies: economic reforms would continue, but under greater central control and at a more measured pace. Investment and construction projects will be slowed or reduced to use existing assets better. Long- and medium-term loans from international commercial banks will be limited to reduce and control foreign debt. Premier Li also said that China would become more discriminating in its approach to foreign investment, "selecting only the best of the competing offers for foreign business investment." (Tyler, 1995)

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<sup>48</sup>The state still owns and operates more than 50 percent of China's industry, dominating machinery production, transportation, energy and finance (Nelan, 1993).

## 2. Investment, Trade and Technology

Foreign trade, investment and technology remain critical to China's economic development. The People's Republic is continuing efforts to "open up" and play a larger role in regional and global economic affairs in the 1990s. It joined the Asia-Pacific Economic Cooperation (APEC) group in November 1991 and is working toward formal membership in the GATT's successor, the World Trade Organization (WTO). Legislation and regulations have been changed since 1990 to encourage foreign investors. For example, time restrictions for establishing joint ventures have been eliminated, some assurances against nationalization made, and some wholly foreign-owned businesses and contractual ventures granted more preferential tax treatment. Foreign banks have been selectively allowed to open branches and conduct loan business and trade financing for foreign firms, joint ventures and the Chinese government's infrastructure projects. The July 1995 opening of a branch of Japan's Bank of Tokyo, Ltd. in Beijing marked the first "intrusion" of a foreign bank in the capital city since overseas capitalists were thrown out in the mid-1950s.

China's official Xinhua news agency has reported that pledged foreign investments amounted to \$306 billion and covered 193,000 projects between 1991 and 1994. Investments in industry accounted for 53 percent of the total and were concentrated in high-technology infrastructural sectors such as transport and post and telecommunications. Xinhua has also reported that foreign investors are looking more to China's central and western regions<sup>49</sup> where labor and energy cost much less than in the developed coastal regions. (*China Business Times*, 1995)

Overseas Chinese ventures account for 75-90 percent of foreign investment in the People's Republic (Simons and Zielenziger, 1994). Hong Kong continues to lead the way, injecting a record \$39.6 billion into the mainland in 1992 (Burton, 1994). Between 2,500-

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<sup>49</sup>So far, the Chinese government has not indicated that it plans to create "Special Economic Zones" in these less-developed regions.

3,000 Taiwanese companies have invested more than \$3 billion in the mainland in the 1990s, despite the delicacy of relations and lack of direct links. Some 400 of Taiwan's 891 footwear industry association's members had set up factories there by 1991. At least 70-80 Taiwanese toymakers had also invested there, and many more were expected to follow. (Abegglen, 1994) Indonesia's Salim Group conglomerate has invested at least \$100 million in mainland projects (Simons and Zielenziger, 1994).

Japan and the United States have both continued to increase direct investment in the People's Republic, but have begun to switch their relative positions since 1990. Although the United States still led in cumulative investment in 1993, American investments for that year totaled \$877 million, while Japan's rose to \$1,691 million (Fisher and Dori, 1994 and Kwan, 1994). American investments have been spread over a wide range of manufacturing sectors and have also concentrated heavily in offshore oil and gas development in the South China Sea. Japanese investments are generally directed to high value-added and capital-intensive projects. Both investors are engaged in a multitude of wholly foreign-owned enterprises and equity and contractual joint ventures that are transferring massive amounts of advanced technology -- from electronics and personal computers to automotive production and power generation.

Big multinational firms are beginning to take hold and are fast gaining a sharp edge over other foreign-funded and local ones. Names like Procter and Gamble, McDonald's and Sony are household names in China. Of Beijing's nearly 2,500 foreign-funded firms, 23 multinationals accounted for 38 percent of total output in 1994. The Xinhua news agency has reported that some of China's markets -- such as detergents -- are virtually monopolized by the multinationals through their dominant stock shares and exclusive use of trademarks. (Reuter, 1995)

Although China exhibits a great deal of "openness" to foreign investment, some hindrances remain. Many of its laws and regulations lack transparency and are unevenly enforced. Foreign investment is still prohibited for projects with objectives that do not match

the state's plan for economic development. Restricted or prohibited categories usually reflect protectionist import substitution policies, avoidance of excess capacity and the aim of limiting luxury items. Limitations such as local content requirements and state designation of Chinese partners for joint ventures in "key" enterprises often make projects too costly and inefficient for foreign investors.

Chinese economic reform strategy in the 1990s relies heavily upon export-led growth. As shown in Table 3-15 below, the total volume of China's trade more than doubled, with exports generally exceeding imports between 1990-94.

Table 3-15. Total Volume of Trade (millions of US dollars).  
(After *The Far East and Australasia*, various and United States Information Service, 1995)

	1990	1991	1992	1993	1994
Total two-way	115,413	135,701	165,608	195,714	236,700
Total exports	62,063	71,910	84,998	91,763	121,000
Total imports	53,350	63,791	80,610	103,951	115,700

The People's Republic has continued to expand trade with a variety of partners, particularly in Asia. In 1991 South Korea became China's fourth largest trading partner, Taiwan its sixth largest<sup>50</sup>. China's proportion of trade with the former Soviet Union, however, is very low. Staying clear of the Soviet economy paid off: when the collapse came, there was little effect on China's economy. (Abegglen, 1994)

Japan has retained the number one position among China's trading partners, followed by Hong Kong and the United States. As shown in Table 3-16 below, the People's Republic has generally imported more from the United States and Japan than it exported to them in the

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<sup>50</sup>By 1992 commerce with the mainland accounted for 10 percent of Taiwan's total trade (Burton, 1994).

1990s. However, in 1993 the deficit with Japan increased more than threefold while trade with the United States literally skyrocketed into surplus.

Table 3-16. Trade with Japan and the United States<sup>51</sup>  
 (millions of U.S. dollars). (After *The Far East and Australasia* and *The Summary Report: Trade of Japan*, various)

	1990	1991	1992	1993
Total exports	62,063	71,910	84,998	91,763
Total imports	53,350	63,791	80,610	103,951
Exports to Japan	8,999	10,252	11,699	15,779
Imports from Japan	10,535	10,032	13,681	23,253
Balance with Japan	-1,536	+220	-1,982	-6,289
Exports to the U.S.	5,180	6,194	8,594	16,964
Imports from U.S.	7,868	8,008	8,900	10,688
Balance with U.S.	-2,688	-1,814	-306	+6,276

Both partners have complained about China's trade and regulatory practices. Japan's most recent complaints have involved intellectual property rights, charges of "dumping" in textiles and cement, and unfair inspection standards for goods imported to China. America's have focused more on the balance of trade, "closed" nature of China's markets and intellectual property rights issues. Trade sanctions by the United States were narrowly avoided by a last-minute settlement in a dispute over copyright and patent protection. Because it must be renewed annually, China's most-favored-nation (MFN) status with the United States is constantly being called to question as frictions develop.

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<sup>51</sup>Figures reflect only direct trade with China; trade conducted through Hong Kong is not included.

Still at stake is China's entry to the World Trade Organization. This will largely depend upon its ability to satisfy member economies' demands that it will stick to international trading rules. Further complicating the matter is the issue of China's status -- whether it is to be considered a "developed" or "developing" country. The People's Republic has been pressing for entry as a "developing" country or at least a lengthy transition period in which to meet WTO requirements. Organization members -- primarily the United States and European countries -- have said that China's economy is already too big for it to be considered a "developing" country. However, there have been signs of a possible break in the impasse. In March 1995 the United States agreed that China "... could be considered as a 'hybrid' member, with a status falling somewhere between a developed and developing country." (Chen, 1995)

### **3. Aid and Loans**

The People's Republic became the world's fifth-largest debtor nation in 1994 as its total foreign debt reached \$100 billion -- about 25 percent of GNP (Chen and Kahn, 1995). While foreign debt is increasing, the nature of China's borrowing is changing. Emphasis is shifting from concessional to market-rate loans. In 1991 China's "soft" credits under the World Bank's International Development Assistance (IDA) program<sup>52</sup> totaled \$971 million, while market-rated loans from the Bank's main window totaled \$601 million. The order was reversed in 1992: China borrowed \$1.58 billion from the main window and only \$948 through the IDA. This trend has continued, with the IDA portion of China's total borrowing falling from 37 to 30 percent between 1992-94. Recent news reports have suggested that China may cease IDA borrowing entirely after 1999. (Lachica, 1995)

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<sup>52</sup>IDA loans are provided to the world's poorest countries. Their terms are for 30 years at interest rates of less than 1 percent.

Bilateral loans and aid from the United States virtually ceased after the 1989 Tiananmen Square incident. Foreign aid in general has become less popular with Congress; the United States gives little or no assistance to any of the more dynamic Asian economies like Indonesia, Thailand and China.

In contrast, Japan has continued to be China's primary single source of loans and ODA. In 1991 multilateral institutions provided 37 percent of China's net ODA; Japan alone provided another 29 percent. That same year, Japan announced a new \$4.6 billion loan package from the Export-Import Bank additional to its multiyear foreign aid package. (Lincoln, 1993). Japanese loans and aid have increased every year. Total low-interest loans and outright grants for fiscal year 1994 amounted to some \$1.61 billion and \$89.9 million, respectively (Dow Jones News, 1995). More big ODA loans are planned through 2001 -- despite major objections to China's continued nuclear testing (Japan Economic Newswire, 1995). The Japanese policy of separating economics and politics is holding firm for China.

## **E. CONCLUSIONS - LOOKING AHEAD**

### **1. Comparative Influence of the United States and Japan**

Economically, the United States and Japan have played large roles in China's development since the 1970s. Both desire peaceful growth in the People's Republic and have displayed a firm commitment not to isolate it as it becomes integrated into the capitalist world economy. Thus far, influence has been roughly equal, but divided in terms of category. Japan has led in aid, loans and trade, while the United States has provided much more investment. China has benefitted from massive transfers of advanced technology from both. Contributions have differed slightly, but were equally significant. For example, the United States provided military equipment (1980s) that Japan could not, and assisted with offshore oil and gas

development; Japan provided much of the technology for China's lucrative textile and steel industries.

Recent trends -- particularly in investment -- indicate that Japan is beginning to pull ahead of the United States in the total volume of transactions with China. Since Japan already leads in volume of aid, loans and trade, this would normally produce the conclusion that Japan is beginning to exert more influence over China's economic development. However, recent trends also indicate that China may be using its trade surplus with the United States to offset its deficit with Japan. And as high yen rates continue to drive up the cost of repaying many Japanese loans, the Chinese government may begin to curtail borrowing from Japan and concentrate on other sources.

Economic development in the People's Republic of China is hardly complete. The nature of Japanese and American importance to the Chinese economy may be changing, but it is doubtful that either will establish a conclusive lead. China's tradition of "self-reliance" and lessons learned from overdependence on the Soviet Union in the 1950s will likely preclude its overdependence on any one partner again. At least in the foreseeable future, the United States and Japan will likely continue sharing roughly equal influence over China's economic development.

## **2. An Evolving Triangle -- What's Next?**

The People's Republic of China requires external assistance to modernize and grow; the United States and Japan are the world's two largest sources of development assistance. Politics and ideology separated China from these sources for a number of years, but have largely taken a "back seat" to economic necessity -- particularly since the 1970s. Like South Korea and the other East Asian newly industrialized economies (NIEs), China has engaged heavily in economic relationships with Japan and the United States for the sake of development. Unlike its East Asian neighbors, however, China has maintained mostly

bilateral economic relationships with foreigners and has largely avoided forming multiple relationships. Table 3-17 below provides a simplified graphic representation of the main economic relationships between the People's Republic of China, Japan and the United States.

Table 3-17. Economic Relationships.

For -- \ -- is \	China	Japan	United States
China	-----	Supplier of Technology Lender of Capital Market	Market Supplier of Technology Investor
Japan	Market Subcontractor Borrower of Capital	-----	Market Supplier of Technology Borrower of Capital
United States	Investment Opportunity Subcontractor Market	Supplier of Technology Supplier of Components, Products and Equipment Market Lender of Capital	-----

China's leadership is using economic growth to maintain internal stability and strengthen the Chinese Communist Party's grip on political power. State control continues to weigh heavily in China's economic relationships with foreign partners. Entanglements leading to dependency are avoided as much as possible. Complex interdependence -- as defined by Robert Keohane and Joseph Nye<sup>53</sup> -- is developing between the People's Republic, Japan and the United States, but with asymmetries that are dissimilar to what the latter two have been accustomed. The three societies are linked by multiple channels; the use of military

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<sup>53</sup>According to Keohane and Nye (1977), complex interdependence exists where: (1) societies are connected by multiple channels -- formal (governmental), informal (non-governmental) and transnational (multinational organizations, etc.); (2) relationships between states consist of multiple issues that are not arranged by any clear or consistent hierarchy; and (3) military force is not used between governments in the region or on the issues over which the interdependence prevails.

force among them is out of the question at this time<sup>54</sup>. However, the issues surrounding China's relationships with its partners are clearly prioritized by the Chinese government. Foreign and domestic policies work hand-in-glove to support the state's domestic goals. The interests of private corporations and non-government organizations do not affect China's foreign policy decisions as they do in many countries. Unlike other recipients of American and Japanese development assistance, the People's Republic has used cooperation and the promise of economic gain as tools to: (1) induce the inflow of their capital and advanced technology; and (2) capitalize on the competition between the two, playing one against the other for maximum gain. As long as these tactics prove successful, the Chinese government will likely continue to manipulate economic relations with Japan and the United States.

China's de-linking of politics and ideology from economics in the 1970s has largely held through the 1990s. Japan has embraced the same approach since the 1950s. However, this is still a difficult task for the United States, especially where human rights issues are involved. President Clinton's May 1994 decision to de-link human rights issues from China's MFN status, although unpopular among certain domestic circles, sent a very positive signal to China and Japan. Continued recognition of differences and increased sensitivity to them will be required of all parties as economic relationships grow and mature.

Even with sustained high rates of growth, it is unlikely that China's economy will compare to those of the United States and Japan in the near future. China's GNP is widely reported as third largest behind these economic giants. However, when put in perspective, the statistic becomes less impressive: by 1994, China's GNP was still less than a tenth of Japan's and less than one-fifteenth of America's (Fisher and Dori, 1994). The size and strength of the American and Japanese economies demand that the two play responsible roles in the Asia-Pacific community. Shared leadership between them is gradually being challenged.

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<sup>54</sup>Regional peace and stability are of common concern to all. Despite several territorial and border disputes, the People's Republic of China faces no real threat of a military confrontation in the foreseeable future.

Their influence has been primarily a 20th century phenomenon, whereas China has a centuries-old tradition of Asian political leadership. Huge economic gains in recent years have rekindled feelings of national pride and confidence in the People's Republic. It is beginning to develop the economic power to assume some of the regional and global roles envisioned by its leaders. Although China is still outclassed economically by the United States and Japan -- and will be for some time -- China is far too big to ignore. The future prosperity and security of the Asia-Pacific region may very well depend upon the development of close cooperation and shared leadership between the United States, Japan and China.

## **IV. SUMMARY AND CONCLUSIONS**

### **A. THE DEVELOPING ECONOMIES**

#### **1. General Development Patterns and Policies**

Central government planning and control have been crucial to economic growth in both the Republic of Korea and the People's Republic of China. Under relatively stable, progressive-minded political leadership, each experienced impressive rates of growth. The striking contrast between South Korea's continuous, steady development and China's pre-1978 pattern of cyclical advancement and regression underscores the importance of political stability to the process of economic development. It also demonstrates the potentially detrimental effects of binding ideology to hard-line politics: witness China's experiences during the 1950s and 1960s. Such practices led to virtual isolation from valuable sources of development assistance and the disastrous "Great Leap" and "Cultural Revolution."

Both countries have used import-substitution, "key" industries and a variety of protectionist levers to promote growth in the manufacturing sector. Similarly, the textile industry played an important early role in the development of both economies, providing large earnings of much-needed foreign exchange. Each has applied a "zone" concept to attract foreign investment and technology: South Korea established free trade zones, China, "Special Economic Zones." However, the South Korean leadership started to concentrate on achieving balanced sectoral and regional growth fairly early in the development process, while China's continued to flail about with policies that promoted some sectors and regions at the expense of others.

## **2. Use of Development Assistance**

Foreign aid was the primary tool used by both the Republic of Korea and the People's Republic of China for achieving postwar recovery and beginning modern economic development. South Korea sustained fast growth by using foreign loans to finance long-term investments and balance-of-payment difficulties. In contrast, China largely rejected the accumulation of foreign debt after the Sino-Soviet split, shutting off this development resource for nearly two decades. Only after "opening up" at the end of the 1970s did foreign aid again play an important role in China's development.

Trade has been used as an engine of growth by both economies; the People's Republic has also used it as a political tool and a primary means of obtaining advanced foreign technology. Whereas South Korean exports steadily increased in sophistication, Chinese exports generally reflected cyclical government policies of "self-reliance" and expansion through the 1980s, alternating between primary and agricultural products and industrial and mineral goods. Both have sought to expand and diversify their collections of trading partners -- particularly within the past ten to fifteen years -- in order to avoid situations of overdependence.

Transfers of advanced foreign technology have also been critical to economic development in South Korea and China. Besides trade, China has become heavily reliant upon foreign investment to acquire advanced technology. Foreign investment plays a lesser role in technology transfers to South Korea; from about the mid-1960s on, emphasis shifted from copying and learning-by-doing to adopting advanced foreign technologies through purchases of licenses and technical assistance. Although South Korea has been open to foreign investment for a much longer time than China, the governments of both countries maintain strict regulatory controls that make the process of investing difficult for foreigners.

## **B. THE SOURCES OF DEVELOPMENT ASSISTANCE**

### **1. General Practices and Policies**

The United States and Japan have both displayed a sense of responsibility for promoting peace and prosperity in East Asia, assuming large roles in the development of the East Asian economies. However, their involvement with the Republic of Korea and the People's Republic of China has revealed several differences in their practices and policies. American foreign aid programs, technology transfer arrangements and, to a certain extent, trade practices have been constrained by political elements largely absent in Japan. Japanese assistance has concentrated more on growth industries and infrastructure, while American assistance has included a military element that Japan cannot legally provide.

### **2. Foreign Aid**

By the 1970s Japan had begun to use foreign aid -- particularly ODA -- as its primary form of development assistance. At about the same time, the United States began paring back its contributions relative to its own GNP. Japan started forwarding large amounts of foreign aid to each developing economy just as soon as it normalized relations with them. In contrast, American foreign aid was not distributed as impartially or uniformly because of constraining political and ideological factors. The United States provided large amounts to the Republic of Korea from the start, including critical security-oriented aid. However, its contributions to the People's Republic of China were delayed even after normalization of relations, restricted by laws prohibiting extension of aid to Communist countries. American foreign aid to China virtually ceased after the 1989 Tiananmen incident; Japan -- China's largest source of loans and ODA -- has continued to increase its contributions every year since.

Foreign aid has lost much of its relative importance in American development assistance programs since the 1950s and 1960s. Aid from the United States tends to focus on supplying food and building "social" infrastructure in the poorest developing economies; when recipients reach a certain level of growth and self-sufficiency, American aid usually decreases and development assistance is provided by other means. Between 1970-90, ODA funds allocated to Asia decreased from nearly 60 to around 10 percent of the United States' total (Abegglen, 1994).

Just the opposite pattern has developed in Japan. Foreign aid has become its dominant form of development assistance. Japanese aid tends to focus on equipment and infrastructure to support industrial growth. Copious amounts of aid -- especially bilateral ODA -- are provided to the relatively well off economies as well as the poorer ones. Between 1970-90, the dollar value of Japan's total aid funds to Asia increased 24 times (Abegglen, 1994). Japan's record as an aid provider to South Korea and China helps to explain why it is widely recognized as Asia's -- and the world's -- largest single source of foreign aid.

### **3. Trade**

Both the United States and Japan have been major sources of imports for the developing economies. As with foreign aid, American trading practices were constrained by political factors during the 1950s and 1960s: trade with the People's Republic of China declined rapidly after the outbreak of the Korean War and was subsequently cut off by the American embargo in 1954. Japan maintained some trade relations with the People's Republic throughout this period, but they were also constrained -- by the Chinese government's ideologically-based policies. Despite periodic difficulties with China, Japan became its largest bilateral trading partner while achieving the same with South Korea in 1965. That was also the year in which the United States became South Korea's largest export market. However,

America's trade with the People's Republic of China did not resume until 1971.<sup>55</sup> Once the American restrictions were removed, it expanded rapidly and the United States began to play a comparable role to Japan in overall regional trade. Japan has continued to lead in total volume of regional trade, maintaining the number one position in China since 1970. The United States has followed closely, holding the top position in South Korea from the 1980s.

#### **4. Foreign Investment**

The United States and Japan have been significant investors in the developing economies. Interestingly enough, they appear to have exchanged attitudes toward direct foreign investment over the past thirty years. In the 1960s Japan led the charge to invest in the Republic of Korea, while Americans were either more cautious or just less interested. Nevertheless, Japan and the United States have remained South Korea's largest and second-largest investors, respectively. The total of Japan's cumulative investment there in 1990 was more than twice that of the United States (*Global Economic and Technological Change*, 1993 and *U.S.-Asia Economic Relations*, 1993).

This pattern did not hold for the rest of the region, however. When the People's Republic of China finally "opened up" to foreign investment at the end of the 1970s, the American investors led the charge and the Japanese kept a more cautious approach. Japan's total annual investments have recently begun to outstrip America's in China, but the United States still holds the lead in cumulative investments there. The 1990 cumulative total for the United States amounted to roughly 130 percent of Japan's (Harding, 1992 and *Global Economic and Technological Change*, 1993).

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<sup>55</sup>This allowed a considerable gap to develop between Japan and the United States in total volume of regional trade.

## 5. Technology Transfer

Massive transfers of advanced technology from the United States and Japan have helped to accelerate economic development in East Asia. Similar to foreign aid and trade, the types of technology transferred -- particularly from the United States -- have been constrained by political elements. However, transfers of most of the technologies necessary to promote economic development and growth have been unrestricted. Both the United States and Japan have expressed concerns over the protection of intellectual property rights, but their apprehensions have not impeded the flow of critical technologies to the developing economies.

Although the total dollar value of technology transfers is difficult to calculate,<sup>56</sup> those from Japan appear to have surpassed America's in quantity. Sheer quantity, however, may not always be the best measure to apply when considering the relative importance of a particular source's transfers to a recipient. Many technologies transferred from the United States and Japan have been similar; many more have not. For example, Japan has furnished a lot of valuable technology for specific growth industries, while the United States has provided important military and dual-use technology. The technologies provided by each have been different in type and quantity, but could be considered equal in overall significance to the developing economies.

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<sup>56</sup>Official statistics exclude informal transfers from sources such as machinery suppliers and independent consultants. These informal means can account for as much as two-thirds of the total transfers and are highly effective.

### C. EAST ASIAN SOLUTIONS TO PROBLEMS OF DEVELOPMENT

As demonstrated by the Republic of Korea and the People's Republic of China, LDCs *can* make extensive use of foreign economic development assistance without losing control -- or sovereignty -- over their economies or the direction of their development. The two cases also confirm that mature, industrialized economies *can* provide large amounts of assistance to LDCs without destroying their own economic futures. Cooperative management of resources is the key to success.

Were the experiences of South Korea and China to be used to create an "East Asian model" of economic development for LDCs worldwide, that model would probably include four main ingredients:

- *Adoption of outward-oriented policies*, particularly export-led growth and attracting foreign investment -- at least in the earlier stages -- to obtain advanced technology,
- *Achievement of macroeconomic stability* through sensitive reaction to imbalances by a relatively autonomous, stable government,
- *Emphasis on education and infrastructure* that expands commensurately with economic growth, and
- *Government intercession* to ensure the protection of national interests and maintain domestic control of the development process.

Such an "East Asian model" is as good as any for ensuring the successful economic development of the world's LDCs. However, the fact remains that no two countries in the world are exactly alike. Each has its own unique set of circumstances -- domestically and internationally -- that will determine the best methods and means for it to use to impel and sustain economic development. The real value of such an "East Asian model" to other

developing economies is that it offers tried and proven *alternatives* from which they can choose -- and modify as necessary -- to fit their individual needs.

#### **D. THE ROLES OF THE UNITED STATES AND JAPAN**

The United States and Japan have both played critical roles in the economic development of the East Asian LDCs. Their influence has been mostly shared, often complementary and divided as to time or category. Japan has not *replaced* the United States as the primary contributor to East Asian development; it has become America's *partner*. Neither could have independently offered half as much assistance to all of the developing East Asian economies as the two have together. Although America's economic position in the region has shown a relative decline, it is still rising in absolute terms. The economic interests of the United States are becoming increasingly intertwined with those of East Asia; large-scale withdrawal -- at least in the foreseeable future -- is highly unlikely.

What *is* likely, however, is the continuation of burden-sharing between the United States and Japan, with Japan as the "senior," the United States as the "junior" partner in East Asian development. Their combined resources will be required for quite some time to come: economic development in East Asia is far from complete. The needs of the developing economies are too great for any country to shoulder alone.

The size and strength of the American and Japanese economies demand a responsible role for each in the Asia-Pacific community. Shared leadership between them has been repeatedly declared as desired by all and is gradually being realized. As the other East Asian economies develop and mature, so should they be included in the sharing of regional leadership. The future prosperity and security of all Asia-Pacific economies may very well depend upon it.

## **E.     IMPLICATIONS FOR FOREIGN AND DOMESTIC POLICY IN THE UNITED STATES**

As America's role in the Asia-Pacific community evolves, its foreign and domestic policies will require adjustment to ensure protection of its national interests. The national interests of the United States are commonly defined in terms of maintaining peace and stability, the spread of freedom and democracy, and free access to markets and transit lanes. Competitiveness -- economic and technological -- is emerging as a new priority. American foreign policy is predicated upon the superiority of market economies and open political institutions as stabilizing agents. Forward deployed forces, maintenance of overseas bases and bilateral security arrangements are the principal elements of the United States' strategy for protecting its regional interests.

Today, American leadership in the Asia-Pacific community is not optional. Interdependence demands active participation; America's size and strength demand a responsible role. But meeting both the nation's domestic needs and global commitments is becoming increasingly difficult. Given the complex environment of rapid economic growth and persisting instability in East Asia -- particularly on the Korean peninsula -- American decision makers need to formulate *complementary* domestic and foreign policies to protect our national interests. Neither set of policies can subordinate the other and produce a favorable outcome over the long run. Long-term interests and the "collective good" cannot be ignored or sacrificed in the resolution of short-term or "special interest" problems. Balancing all the variables is not an easy or comfortable task. As a start, our domestic policy initiatives should aim to:

- Reduce the budget deficit through domestic means,
- Encourage a higher domestic savings rate,

- Improve education in general and provide retraining for workers in noncompetitive industries, and
- Improve American “international” education and awareness.

Foreign policy initiatives should aim to:

- Make a clearer statement of America’s interests and strategies,
- Clarify the perception of leadership with due attention to the responsibilities of partnership and burden sharing,
- Give due consideration to relationships with *all* nations of the Asia-Pacific community -- not just allies and friends,
- Remain uncommitted wherever possible to avoid conflict of interests between partnerships; use organizations such as the UN, NATO and ASEAN as “common ground,”
- Support and promote an international division of labor,
- Promote international joint ventures and corporate alliances, particularly in research and development (R&D) initiatives,
- Support, promote and use the WTO; avoid protectionism,
- Maintain a forward-deployed status, and
- Express concern over issues of human rights and democracy, but remain open-minded regarding different cultures and political institutions.

The United States has been heavily relied upon over the past half-century to provide international leadership. As the one remaining “superpower” in these early years of the post-Cold War era, America’s global responsibilities have not diminished. Therefore it is especially important now that we not lose sight of our responsibilities -- and our position -- within the international community.

At a time when America is able neither to dominate the world nor to withdraw from it, when it finds itself both all-powerful and totally vulnerable, it must not abandon the ideals that have accounted for its greatness. But neither must it jeopardize that greatness by fostering illusions about the extent of its reach. World leadership is inherent in America's power and values, but it does not include the privilege of pretending that America is doing other nations a kindness by associating with them, or that it has a limitless capacity to impose its will by withholding its favors. (Kissinger, 1994)



## **APPENDIX A. MUTUAL DEFENSE TREATY BETWEEN THE UNITED STATES OF AMERICA AND THE REPUBLIC OF KOREA**

*Following is the text of the Mutual Defense Treaty signed at Washington, D.C. on October 1, 1953, ratified by the U.S. Senate on January 26, 1954, ratified by the President of the United States on February 5, 1954, and ratified by the Republic of Korea on January 29, 1954. Ratifications were exchanged at Washington on November 17, 1954, proclaimed by the President of the United States on December 1, 1954, and entered into force on November 17, 1954 (United States Treaties and Other International Agreements, 1956).*

The Parties to this Treaty,

Reaffirming their desire to live in peace with all peoples and all governments, and desiring to strengthen the fabric of peace in the Pacific area,

Desiring to declare publicly and formally their common determination to defend themselves against external armed attack so that no potential aggressor could be under the illusion that either of them stands alone in the Pacific area,

Desiring further to strengthen their efforts for collective defense for the preservation of peace and security pending the development of a more comprehensive and effective system of regional security in the Pacific area,

Have agreed as follows:

### **ARTICLE I**

The Parties undertake to settle any international disputes in which they may be involved by peaceful means in such a manner that international peace and security and justice are not endangered and to refrain in their international relations from the threat or use of force in any manner inconsistent with the Purposes of the United Nations, or obligations assumed by any Party toward the United Nations.

### **ARTICLE II**

The Parties will consult together whenever, in the opinion of either of them, the political independence or security of either of the Parties is threatened by external armed attack. Separately and jointly, by self help and mutual aid, the Parties will maintain and develop appropriate means to deter armed attack and will take suitable measures in consultation and agreement to implement this Treaty and to further its purposes.

### **ARTICLE III**

Each Party recognizes that an armed attack in the Pacific area on either of the Parties in territories now under their respective administrative control, or hereafter recognized by one of the Parties as lawfully brought under the administrative control of the other, would be dangerous to its own peace and safety and declares that it would act to meet the common danger in accordance with its constitutional processes.

### **ARTICLE IV**

The Republic of Korea grants, and the United States of America accepts, the right to dispose United States land, air and sea forces in and about the territory of the Republic of Korea as determined by mutual agreement.

### **ARTICLE V**

This Treaty shall be ratified by the United States of America and the Republic of Korea in accordance with their respective constitutional processes and will come into force when instruments of ratification thereof have been exchanged by them at Washington.

### **ARTICLE VI**

This Treaty shall remain in force indefinitely. Either Party may terminate it one year after notice has been given to the other Party.

IN WITNESS WHEREOF the undersigned Plenipotentiaries have signed this Treaty.  
DONE in duplicate at Washington, in the English and Korean languages, this first day of October 1953.

FOR THE UNITED STATES OF AMERICA:      FOR THE REPUBLIC OF KOREA:

John Foster Dulles

Y. T. Pyun

## **APPENDIX B. TREATY OF MUTUAL COOPERATION AND SECURITY BETWEEN THE UNITED STATES OF AMERICA AND JAPAN**

*Following is the text of the Treaty of Mutual Cooperation and Security signed at Washington, D.C. on January 19, 1960, ratified by the U.S. Senate on June 22, 1960, ratified by the President of the United States on June 22, 1960, and ratified by Japan on June 21, 1960. Ratifications were exchanged at Tokyo on June 23, 1960, proclaimed by the President of the United States on June 27, 1960, and entered into force on June 23, 1960 (United States Treaties and Other International Agreements, 1961).*

The United States of America and Japan,

Desiring to strengthen the bonds of peace and friendship traditionally existing between them, and to uphold the principles of democracy, individual liberty, and the rule of law,

Desiring further to encourage closer economic cooperation between them and to promote conditions of economic stability and well-being in their countries,

Reaffirming their faith in the purposes and principles of the Charter of the United Nations, and their desire to live in peace with all peoples and all governments,

Recognizing that they have the inherent right of individual or collective self-defense as affirmed in the Charter of the United Nations,

Considering that they have a common concern in the maintenance of international peace and security in the Far East,

Having resolved to conclude a treaty of mutual cooperation and security,

Therefore agree as follows:

### **ARTICLE I**

The Parties undertake, as set forth in the Charter of the United Nations, to settle any international disputes in which they may be involved by peaceful means in such a manner that international peace and security and justice are not endangered and to refrain in their international relations from the threat or use of force against the territorial integrity or political independence of any state, or in any other manner inconsistent with the purposes of the United Nations.

The Parties will endeavor in concert with other peace-loving countries to strengthen the United Nations so that its mission of maintaining international peace and security may be discharged more effectively.

## **ARTICLE II**

The Parties will contribute toward the further development of peaceful and friendly international relations by strengthening their free institutions, by bringing about a better understanding of the principles upon which these institutions are founded, and by promoting conditions of stability and well-being. They will seek to eliminate conflict in their international economic policies and will encourage economic collaboration between them.

## **ARTICLE III**

The Parties, individually and in cooperation with each other, by means of continuous and effective self-help and mutual aid will maintain and develop, subject to their constitutional provisions, their capacities to resist armed attack.

## **ARTICLE IV**

The Parties will consult together from time to time regarding the implementation of this Treaty, and, at the request of either Party, whenever the security of Japan or international peace and security in the Far East is threatened.

## **ARTICLE V**

Each Party recognizes that an armed attack against either Party in the territories under the administration of Japan would be dangerous to its own peace and safety and declares that it would act to meet the common danger in accordance with its constitutional provisions and processes.

Any such armed attack and all measures taken as a result thereof shall be immediately reported to the Security Council of the United Nations in accordance with the provisions of Article 51 of the Charter. Such measures shall be terminated when the Security Council has taken the measures necessary to restore and maintain international peace and security.

## **ARTICLE VI**

For the purpose of contributing to the security of Japan and the maintenance of international peace and security in the Far East, the United States of America is granted the use by its land, air and naval forces of facilities and areas in Japan.

The use of these facilities and areas as well as the status of United States armed forces in Japan shall be governed by a separate agreement, replacing the Administrative Agreement under Article III of the Security Treaty between the United States of America and Japan, signed at Tokyo on February 28, 1952, as amended, and by such other arrangements as may be agreed upon.

## **ARTICLE VII**

This Treaty does not affect and shall not be interpreted as affecting in any way the rights and obligations of the Parties under the Charter of the United Nations or the responsibility of the United Nations for the maintenance of international peace and security.

## **ARTICLE VIII**

This Treaty shall be ratified by the United States of America and Japan in accordance with their respective constitutional processes and will enter into force on the date on which the instruments of ratification thereof have been exchanged by them in Tokyo.

## **ARTICLE IX**

The Security Treaty between the United States of America and Japan signed at the city of San Francisco on September 8, 1951 shall expire upon the entering into force of this Treaty.

## **ARTICLE X**

This Treaty shall remain in force until in the opinion of the Governments of the United States of America and Japan there shall have come into force such United Nations arrangements as will satisfactorily provide for the maintenance of international peace and security in the Japan area.

However, after the Treaty has been in force for ten years, either Party may give notice to the other Party of its intention to terminate the Treaty, in which case the Treaty shall terminate one year after such notice has been given.

IN WITNESS WHEREOF the undersigned Plenipotentiaries have signed this Treaty.

DONE in duplicate at Washington in the English and Japanese languages, both equally authentic, this 19th day of January, 1960.

FOR THE UNITED STATES OF AMERICA:

Christian A. Herter  
Douglas MacArthur 2nd  
J. Graham Parsons

FOR JAPAN:

Nobusuke Kishi  
Aüichiro Fujiyama  
Mitsuiro Ishii  
Tadashi Adachi  
Koichiro Asakai

## APPENDIX C. JOINT COMMUNIQUE BETWEEN THE PEOPLE'S REPUBLIC OF CHINA AND THE UNITED STATES OF AMERICA

*Following is the text of the joint Sino-American document commonly called the "Shanghai Communique," dated February 27, 1972 (Harding, 1992).*

President Richard Nixon of the United States of America visited the People's Republic of China at the invitation of Premier Chou En-lai of the People's Republic of China from February 21 to February 28, 1972. Accompanying the President were Mrs. Nixon, U.S. Secretary of State William Rogers, Assistant to the President Dr. Henry Kissinger, and other American officials.

President Nixon met with Chairman Mao Tse-tung of the Communist Party of China on February 21. The two leaders had a serious and frank exchange of views on Sino-U.S. relations and world affairs.

During the visit, extensive, earnest, and frank discussions were held between President Nixon and Premier Chou En-lai on the normalization of relations between the United States of America and the People's Republic of China, as well as on other matters of interest to both sides. In addition, Secretary of State William Rogers and Foreign Minister Chi P'eng-fei held talks in the same spirit.

President Nixon and his party visited Peking and viewed cultural, industrial and agricultural sites, and they also toured Hangchow and Shanghai where, continuing discussions with Chinese leaders, they viewed similar places of interest.

The leaders of the People's Republic of China and the United States of America found it beneficial to have this opportunity, after so many years without contact, to present candidly to one another their views on a variety of issues. They reviewed the international situation in which important changes and great upheavals are taking place and expounded their respective positions and attitudes.

The U.S. side stated: Peace in Asia and peace in the world requires efforts both to reduce immediate tensions and to eliminate the basic causes of conflict. The United States will work for a just and secure peace: just, because it fulfills the aspirations of peoples and nations for freedom and progress; secure, because it removes the danger of foreign aggression. The United States supports individual freedom and social progress for all the peoples of the world, free of outside pressure or intervention. The United States believes that the effort to reduce tensions is served by improving communication between countries that have different ideologies so as to lessen the risks of confrontation through accident, miscalculation or misunderstanding. Countries should treat each other with mutual respect and be willing to compete peacefully, letting performance be the ultimate judge. No country should claim infallibility and each country should be prepared to re-examine its own attitudes for the common good. The United States stressed that the peoples of Indochina should be

allowed to determine their destiny without outside intervention; its constant primary objective has been a negotiated solution; the eight-point proposal put forward by the Republic of Vietnam and the United States on January 27, 1972 represents a basis for the attainment of that objective; in the absence of a negotiated settlement the United States envisages the ultimate withdrawal of all U.S. forces from the region consistent with the aim of self-determination for each country of Indochina. The United States will maintain its close ties with and support for the Republic of Korea; the United States will support efforts of the Republic of Korea to seek a relaxation of tension and increased communication in the Korean peninsula. The United States places the highest value on its friendly relations with Japan; it will continue to develop the existing close bonds. Consistent with the United Nations Security Council Resolution of December 21, 1971, the United States favors the continuation of the ceasefire between India and Pakistan and the withdrawal of all military forces to within their own territories and to their own sides of the ceasefire line in Jammu and Kashmir; the United States supports the right of the peoples of South Asia to shape their own future in peace, free of military threat, and without having the area become the subject of great power rivalry.

The Chinese side stated: Wherever there is oppression, there is resistance. Countries want independence, nations want liberation and the people want revolution -- this has become the irresistible trend of history. All nations, big or small, should be equal; big nations should not bully the small and strong nations should not bully the weak. China will never be a superpower and it opposes hegemony and power politics of any kind. The Chinese side stated that it firmly supports the struggles of all the oppressed people and nations for freedom and liberation and that the people of all countries have the right to choose their social systems according to their own wishes and the right to safeguard the independence, sovereignty and territorial integrity of their own countries and oppose foreign aggression, interference, control and subversion. All foreign troops should be withdrawn to their own countries.

The Chinese side expressed its firm support to the peoples of Vietnam, Laos, and Cambodia in their efforts for the attainment of their goal and its firm support to the seven-point proposal of the Provisional Revolutionary Government of the Republic of South Vietnam and the elaboration of February this year on the two key problems in the proposal, and to the Joint Declaration of the Summit Conference of the Indochinese Peoples. It firmly supports the eight-point program for the peaceful unification of Korea put forward by the Government of the Democratic People's Republic of Korea on April 12, 1971, and the stand for the abolition of the "U.N. Commission for the Unification and Rehabilitation of Korea." It firmly opposes the revival and outward expansion of Japanese militarism and firmly supports the Japanese people's desire to build an independent, democratic, peaceful and neutral Japan. It firmly maintains that India and Pakistan should, in accordance with the United Nations resolutions on the India-Pakistan question, immediately withdraw all their forces to their respective territories and to their own sides of the ceasefire line in Jammu and Kashmir and firmly supports the Pakistan Government and people in their struggle to preserve

their independence and sovereignty and the people of Jammu and Kashmir in their struggle for the right of self-determination.

There are essential differences between China and the United States in their social systems and foreign policies. However, the two sides agreed that countries, regardless of their social systems, should conduct their relations on the principles of respect for the sovereignty and territorial integrity of all states, non-aggression against other states, non-interference in the internal affairs of other states, equality and mutual benefit, and peaceful coexistence. International disputes should be settled on this basis, without resorting to the use or threat of force. The United States and the People's Republic of China are prepared to apply these principles to their mutual relations.

With these principles of international relations in mind the two sides stated that:

- progress toward the normalization of relations between China and the United States is in the interests of all countries;
- both wish to reduce the danger of international military conflict;
- neither should seek hegemony in the Asia-Pacific region and each is opposed to efforts by any other country or group of countries to establish such hegemony; and
- neither is prepared to negotiate on behalf of any third party or to enter into agreements or understandings with the other directed at other states.

Both sides are of the view that it would be against the interests of the peoples of the world for any major country to collude with another against other countries, or for major countries to divide up the world into spheres of interest.

The two sides reviewed the long-standing serious disputes between China and the United States. The Chinese side reaffirmed its position: The Taiwan question is the crucial question obstructing the normalization of relations between China and the United States; the Government of the People's Republic of China is the sole legal government of China; Taiwan is a province of China which has long been returned to the motherland; the liberation of Taiwan is China's internal affair in which no other country has the right to interfere; and all U.S. forces and military installations must be withdrawn from Taiwan. The Chinese Government firmly opposes any activities which aim at the creation of "one China, one Taiwan," "one China, two governments," "two Chinas," and "independent Taiwan" or advocate that "the status of Taiwan remains to be determined."

The U.S. side declared: The United States acknowledges that all Chinese on either side of the Taiwan Strait maintain there is but one China and that Taiwan is a part of China. The United States Government does not challenge that position. It reaffirms its interest in a peaceful settlement of the Taiwan question by the Chinese themselves. With this prospect in mind, it affirms the ultimate objective of the withdrawal of all U.S. forces and military installations from Taiwan. In the meantime, it will progressively reduce its forces and military installations on Taiwan as the tension in the area diminishes.

The two sides agreed that it is desirable to broaden the understanding between the two peoples. To this end, they discussed specific areas in such fields as science, technology, culture, sports and journalism, in which people-to-people contacts and exchanges would be mutually beneficial. Each side undertakes to facilitate the further development of such contacts and exchanges.

Both sides view bilateral trade as another area from which mutual benefit can be derived, and agreed that economic relations based on equality and mutual benefit are in the interest of the peoples of the two countries. They agree to facilitate the progressive development of trade between their two countries.

The two sides agreed that they will stay in contact through various channels, including the sending of a senior U.S. representative to Peking from time to time for concrete consultations to further the normalization of relations between the two countries and continue to exchange views on issues of common interest.

The two sides expressed the hope that the gains achieved during this visit would open up new prospects for the relations between the two countries. They believe that the normalization of relations between the two countries is not only in the interest of the Chinese and American peoples but also contributes to the relaxation of tension in Asia and the world.

President Nixon, Mrs. Nixon and the American party expressed their appreciation for the gracious hospitality shown them by the Government and people of the People's Republic of China.

## APPENDIX D. COMMUNIQUE BETWEEN JAPAN AND THE PEOPLE'S REPUBLIC OF CHINA

*Following is the text of the communique signed September 29, 1972 by Prime Minister Kakuei Tanaka of Japan and Premier Zhou Enlai (Chou En-lai) of the People's Republic of China (Lee, 1976).*

At the invitation of Premier Chou En-lai of the State Council of the People's Republic of China, Prime Minister Tanaka Kakuei of Japan visited the People's Republic of China from September 25 to 30, 1972. Accompanying Prime Minister Tanaka Kakuei were Foreign Minister Ohira Masayoshi, Chief Cabinet Secretary Nikaido Susumu and other government officials.

Chairman Mao Tse-tung met Prime Minister Tanaka Kakuei on September 27. The two sides had an earnest and friendly conversation.

Premier Chou En-lai and Foreign minister Chi Peng-fei had an earnest and frank exchange of views with Prime Minister Tanaka Kakuei and Foreign Minister Ohira Masayoshi, all along in a friendly atmosphere, on various matters between the two countries and other matters of interest to both sides, with the normalization of relations between China and Japan as the focal point, and the two sides agreed to issue the following joint statement of the two Governments:

China and Japan are neighboring countries separated only by a strip of water, and there was a long history of traditional friendship between them. The two peoples ardently wish to end the abnormal state of affairs that has hitherto existed between the two countries. The termination of the state of war and the normalization of relations between China and Japan -- the realization of such wishes of the two peoples will open a new page in the annals of relations between the two countries.

The Japanese side is keenly aware of Japan's responsibility for causing enormous damages in the past to the Chinese people through war and deeply reproaches itself. The Japanese side reaffirms its position that in seeking to realize the normalization of relations between Japan and China, it proceeds from the stand of fully understanding the three principles for the restoration of diplomatic relations put forward by the Government of the People's Republic of China. The Chinese side expresses its welcome for this.

Although the social systems of China and Japan are different, the two countries should and can establish peaceful and friendly relations. The normalization of relations and the development of good neighborly and friendly relations between the two countries are in the interests of the two peoples, and will also contribute to the relaxation of tension in Asia and the safeguard of world peace.

(1) The abnormal state of affairs which has hitherto existed between the People's Republic of China and Japan is declared terminated on the date of publication of this statement.

(2) The Government of Japan recognizes the Government of the People's Republic of China as the sole legal government of China.

(3) the Government of the People's Republic of China reaffirms that Taiwan is an inalienable part of the territory of the People's Republic of China. The Government of Japan fully understands and respects this stand of the Government of China and adheres to its stand of complying with Article 8 of the Potsdam Proclamation.

(4) The Government of the People's Republic of China and the Government of Japan have decided upon the establishment of diplomatic relations as from September 29, 1972. The two Governments have decided to adopt all necessary measures for the establishment and the performance of functions of embassies in each other's capitals in accordance with international law and practice and exchange ambassadors as speedily as possible.

(5) The Government of the People's Republic of China declares that in the interest of the friendship between the peoples of China and Japan, it renounces its demand for war indemnities from Japan.

(6) The Government of the People's Republic of China and the Government of Japan agree to establish durable relations of peace and friendship between the two countries on the basis of the principles of mutual respect for sovereignty and territorial integrity, mutual nonaggression, noninterference in each other's internal affairs, equality and mutual benefit and peaceful coexistence.

In keeping with the foregoing principles and the principles of the United Nations Charter, the Governments of the two countries affirm that in their mutual relations, all disputes shall be settled by peaceful means without resorting to the use or threat of force.

(7) The normalization of relations between China and Japan is not directed against third countries. Neither of the two countries should seek hegemony in the Asia-Pacific region and each country is opposed to efforts by any country or group of countries to establish such hegemony.

(8) To consolidate and develop the peaceful and friendly relations between the two countries, the Government of the People's Republic of China and the Government of Japan agree to hold negotiations aimed at the conclusion of a treaty of peace and friendship.

(9) In order to further develop the relations between the two countries and broaden the exchange of visits, the Government of the People's Republic of China and the Government of Japan agree to hold negotiations aimed at the conclusion of agreements on trade, navigation, aviation, fishery, etc., in accordance with the needs and taking into consideration the existing nongovernmental agreements.

## APPENDIX E. COMMUNIQUE BETWEEN THE UNITED STATES OF AMERICA AND THE PEOPLE'S REPUBLIC OF CHINA

*Following is the text of a communique between Henry A. Kissinger of the United States and Zhou Enlai (Chou En-lai) of the People's Republic of China that was considered a prelude to normalization of relations between the two countries, as made available by the White House on February 22, 1973. (Dickinson, ed., 1973).*

Dr. Henry A. Kissinger, Assistant to the U.S. President for National Security Affairs, visited the People's Republic of China from February 15 to February 19, 1973. He was accompanied by Herbert G. Klein, Alfred Le S. Jenkins, Richard T. Kennedy, John H. Holdridge, Winston Lord, Jonathan T. Howe, Richard Solomon, and Peter W. Rodman.

Chairman Mao Tse-tung received Dr. Kissinger. Dr. Kissinger (and) members of his party held wide-ranging conversations with Premier Chou En-lai, Foreign Minister Chi Peng-fei, Vice Foreign Minister Chiao Kuan-hua, and other Chinese officials. Mr. Jenkins held parallel talks on technical subjects with Assistant Foreign Minister Chang Wen-chin. All these talks were conducted in an unconstrained atmosphere and were earnest, frank and constructive.

The two sides reviewed the development of relations between the two countries in the year that has passed since President Nixon's visit to the People's Republic of China and other issues of mutual concern. They reaffirmed the principles of the Joint Communique issued at Shanghai in February 1972 and their joint commitment to bring about a normalization of relations. They held that the progress that has been made during this period is beneficial to the people of their two countries.

The two sides agreed that the time was appropriate for accelerating the normalization of relations. To this end, they undertook to broaden their contacts in all fields. They agreed on a concrete program of expanding trade as well as scientific, cultural and other exchanges.

To facilitate this process and to improve communications, it was agreed that in the near future each side will establish a liaison office in the capital of the other. Details will be worked out through existing channels.

The two sides agreed that normalization of relations between the United States and the People's Republic of China will contribute to the relaxation of tension in Asia and in the world.

Dr. Kissinger and his party expressed their deep appreciation for the warm hospitality extended to them.



## APPENDIX F. PEACE TREATY BETWEEN JAPAN AND THE PEOPLE'S REPUBLIC OF CHINA

*Following is the text (unofficial translation) of the peace treaty signed August 12, 1978 by representatives of Japan and the People's Republic of China (China: U.S. Policy Since 1945, 1980).*

Japan and the People's Republic of China, recalling with satisfaction that since the government of Japan and the government of the People's Republic of China issued a joint communique in (Peking) on September 29, 1972, the friendly relations between the two governments and the peoples of the two countries have developed greatly on a new basis.

Confirming that the above mentioned joint communique constitutes the basis of the relations of peace and friendship between the two countries and that the principles enunciated in the joint communique should be strictly observed.

Confirming that the principles of the charter of the United Nations should be fully respected.

Hoping to contribute to peace and stability in Asia and in the world.

For the purpose of solidifying and developing the relations of peace and friendship between the two countries,

Have resolved to conclude a treaty of peace and friendship and for that purpose have appointed as their plenipotentiaries:

Japan:

Minister for Foreign  
Affairs Sunao Sonoda

People's Republic of China:

Minister of Foreign  
Affairs Huang Hua

Who, having communicated to each other their full powers, found to be in good and due form, have agreed as follows:

### ARTICLE I

1. The contracting parties shall develop relations of perpetual peace and friendship between the two countries on the basis of the principles of mutual respect for sovereignty and territorial integrity, mutual non-aggression, non-interference in each other's internal affairs, equality and mutual benefit and peaceful co-existence.

2. The contracting parties confirm that, in conformity with the foregoing principles and the principles of the charter of the United Nations, they shall in their mutual relations settle all disputes by peaceful means and shall refrain from the use or threat of force.

## **ARTICLE II**

The contracting parties declare that neither of them should seek hegemony in the Asia-Pacific region or in any other region and that each is opposed to efforts by any other country or group of countries to establish such hegemony.

## **ARTICLE III**

The contracting parties shall, in the good-neighborly and friendly spirit and in conformity with the principles of equality and mutual benefit and non-interference in each other's internal affairs, endeavor to further develop economic and cultural relations between the two countries and to promote exchanges between the peoples of the two countries.

## **ARTICLE IV**

The present treaty shall not affect the position of either contracting party regarding its relations with third countries.

## **ARTICLE V**

1. The present treaty shall be ratified and shall enter into force on the date of the exchange of instruments of ratification which shall take place at Tokyo. The present treaty shall remain in force for ten years and thereafter shall continue to be in force until terminated in accordance with the provisions of paragraph 2.

2. Either contracting party may, by giving one year's written notice to the other contracting party, terminate the present treaty at the end of the initial ten-year period or at any time thereafter.

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